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AUDITING

AN INTRODUCTION TO PRACTICE

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AUDITING

AN INTRODUCTION TO PRACTICE

BY

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PREFACE

Since the field of Auditing is so extensive, the standard manuals are of necessity somewhat voluminous and cumbersome; furthermore, a considerable portion of their subject matter is intended only for the use of practicing auditors. These factors are responsible for the present publication, a book written primarily for the student, which deals with the general principles underlying every audit and at the same time serves as an introduction to more detailed works.

It has been the author's aim to present the foundation or groundwork with which every auditing student should be familiar, and to explain the reasons and principles upon which every topic is based, without going back and epitomizing the general principles of accounting, a knowledge of which is assumed. For this reason, specialized audits have been omitted. The principles have been set forth accurately and soundly with a view to enabling the student to comprehend the work of an auditor and to apply this knowledge in a satisfactory manner in actual auditing practice.

Chapter XIV, on The Business Budget, has been included because of the frequent necessity of giving budgetary advice in connection with auditing and as a separate general service. It has not been possible to treat this subject fully in the limited space, but it is hoped that the material offered will prove valuable to students of auditing.

Of major importance in connection with the text matter offered are the questions and problems in the Appendix and the term problem which is included as Chapter XV. The material of the first fourteen chapters constitutes the work of the first semester, whereas the illustrative study problem represents the work of the second term. The questions and problems are classified and arranged to correspond with the development of the subject matter. The purposes of the term problem are indicated on page 255, *post*. Those who use this book should realize that every

problem emphasizes the practical application of the principles involved and should therefore receive careful study. In many courses it will not be possible to assign all the practice work for each chapter; and consequently the assignments may be altered considerably from year to year.

GEORGE E. BENNETT

SYRACUSE, NEW YORK.
January, 1925.

TABLE OF CONTENTS

CHAPTER		PAGE
I.	INTRODUCTION AND ORIENTATION	1
	Auditing: Nature and Definition; Relation to Accounting; Audit Purposes and Advantages; Fraud in Accounts; Detection of Errors; Economic Function of Auditing; Legal Regulation of the Profession; Auditor's Qualifications; Legal Responsibility of Auditors.	
II.	SCOPE OF AN AUDIT	13
	Expenditures Apportioned between Capital and Revenue; Internal Checks; The First Audit; Vouchers; Principle of Charge and Discharge; Detailed Audit; Balance Sheet Audit; Sundry Kinds of Audits; Specific Responsibility under Varying Audit Conditions; Classes of Professional Auditors; The Engagement or Case; Auditor's Attitude and Conduct with Office Force; Working Papers; Paper Color and Quality — Use of Ink; Working Paper Rulings; Working Paper Content and Filing.	
III.	COMMENCING THE AUDIT ENGAGEMENT	41
	Scope of Engagement; Check Marks and Their Use; Preliminary Work; Cash Count; Cash Schedule; Trivial Errors; Notes Count; Notes Receivable Schedule; Securities Count; Securities Schedules; Bank Confirmation; General Ledger Trial Balance: Work Sheets; Content of Basic Working Sheets; Reading the Minutes.	
IV.	AUDITING CASH	64
	Plan of Audit; Mechanics of Auditing; Illustrative Audit Plan for Cash; Internal Checks Related to Cash; Verification of Cash — Receipts Deposited Intact; Exchange, Collection, and Interest Items; Bank Reconciliation Procedure; Bank Reconciliation Statement.	
V.	AUDITING CASH (*Continued*)	80
	Bank Pass Book; Auditing after Close of Period Covered; Check Kiting; Verification of Cash — Receipts Used in Part for Petty Cash Purposes; Vouching the Debit Side of the Cash Book; Vouching the Credit Side of the Cash Book; Vouching Payments in Settlement of Purchase Ledger Accounts and Payments to be Debited to Impersonal Accounts; Indorsed Checks as Vouchers for Payments Made; Vouching Payments for Wages, Salaries, Commissions, etc.; Petty Cash; Proving Cash through Other Accounts; Footing the Cash Book; Columnar Cash Book; Balance Sheet Audit *versus* Detailed Audit — Cash; Overdrafts on the Balance Sheet; Suggestions of Auditor on System — No System of Internal Check.	

CHAPTER PAGE

VI. AUDIT OF THE ASSET ACCOUNTS: NOTES RECEIVABLE — SECURITIES 96

Introduction; Illustrative Balance Sheet; Scope of Asset Verification; Title to Assets; Current Assets; Audit of Notes (Bills, Drafts, and Trade Acceptances) Receivable; Inspection and Verification of Notes (and Bills) Receivable; Notes Receivable Discounted — Contingent Liability; Listing and Auditing Notes Receivable — Federal Reserve Suggestions; Account Analysis; Notes Receivable Account Analysis; Notes Receivable Conclusion; Securities — Investments; Stocks of Subsidiary Companies; Interest Investments; Dividend Investments; General Points of Interest Concerning Securities; Investments on the Balance Sheet; Sinking Fund Assets; Listing and Auditing Securities — Federal Reserve Suggestions.

VII. AUDIT OF THE ASSET ACCOUNTS (*Continued*): ACCOUNTS RECEIVABLE; TRADING TRANSACTIONS RELATED TO SALES 118

Introduction; System of Accounting and of Internal Check; Sales on Credit; Cash Sales; Sales Returns; Sales Allowances; Sundry Items Treated as Sales in Error; Illustrative Audit Plan: Sales, etc.; Internal Check and the Sales Ledgers; Verification of Postings; Verification of Balances; Accounts Receivable Components; Accounts Receivable Control not Used; Illustrative Audit Plan: Accounts Receivable; Preparing and Checking Accounts Receivable Schedule; Branch Customers' Accounts; Accounts Receivable Other than Customers; Ageing Accounts Receivable: to Determine Collectibility; Valuing Accounts Receivable: General Conditions; Valuing Accounts Receivable: Bad and Doubtful Debts; Sales Discounts — Returns and Allowances; Accounts Receivable Pledged; Circularization of Accounts Receivable; Proving Accounts Receivable Through Sales and Cash; Auditing Accounts Receivable; Federal Reserve Suggestions.

VIII. AUDIT OF THE ASSET ACCOUNTS (*Continued*): INVENTORIES 139

Introduction; Inventories: Components; Inventory Problem; Inventory Responsibility; Internal Check; Illustrative Audit Plan: Inventories; Trading Inventories; Proving Trading Inventories in Total; Manufacturing Inventories: Raw Materials or Stores; Manufacturing Inventories: Work in Process and Finished Goods; Proving Manufacturing Inventories in Total; Manufacturing Inventories: Scrap; Supervising the Taking of an Inventory; Holding and Subsidiary Company Inventories; Auditing the Inventory: Federal Reserve Suggestions.

IX. AUDIT OF THE ASSET ACCOUNTS (*Continued*): LAND; BUILDINGS 162

Fixed Assets; Account Analyses; Land; Land Companies; Buildings.

CHAPTER PAGE

X. AUDIT OF THE ASSET ACCOUNTS (*Continued*): SUNDRY PROPERTIES; INTANGIBLES; DEFERRED CHARGES 174

Other Properties; Scrapped Properties; Cost of Fixed Property: Federal Reserve Suggestions; Intangible Assets; Deferred Charges; Deferred Charges to Operation: Federal Reserve Suggestions.

XI. AUDIT OF THE LIABILITY ACCOUNTS 185

Introduction; General Principles Underlying the Verification of All of the Liabilities; Notes (and Loans) Payable; Accounts Payable; Accrued Liabilities; Deferred Income; Contingent Liabilities; Fixed Liabilities; Conclusion.

XII. PROPRIETORSHIP; RESERVES; INCOME AND EXPENSE . 203

Capital; Capital Stock; Opening Entries; Subsidiary Company Holdings; Reserves; Surplus; No Par Value Capital Stock; Profit and Loss Account; Income Accounts; Expense Accounts; Journal; Conclusion.

XIII. THE AUDIT REPORT 227

Closing the Audit; Working Paper Index; Criticism of Working Papers; Report Components; Statements; Graphs and Charts; Report Comments; Certificate of Audit; Letter of Submittal; Form of Report; Suggested Basic Statements; Conclusion.

XIV. THE BUSINESS BUDGET 244

Introduction; Budgeting Defined; Business Thermometers and Barometers; The Business Cycle; Barometric Factors; Budget Use; Budget Procedure; Budget Form.

XV. THE FIRST AUDIT. AN ILLUSTRATIVE STUDY PROBLEM 255

A Term Problem Representing a Correlated Review of the Principles of Auditing Studied; Working Papers and Audit Procedure Illustrated.

APPENDIX. QUESTIONS AND PROBLEMS FOR CHAPTER REVIEW 281

INDEX 373

AUDITING

AN INTRODUCTION TO PRACTICE

AUDITING

CHAPTER I

INTRODUCTION AND ORIENTATION

Auditing: Nature and Definition. — A modern audit aims to verify the accounting records of a business in such a manner that the report submitted thereon, in the auditor's opinion, reflects its correct condition and progress. Primarily, an audit aims to verify the Balance Sheet, but since this statement must include, in one form or another, the balance of the Profit and Loss account, an audit should cover, also, a review of that account.

Auditing, therefore, may be defined as intelligently and systematically examining the financial transactions of a business as recorded, compiled, and presented — in books, accounts, and vouchers — to secure such information as shall enable the auditor to satisfy himself whether or not the Balance Sheet has been drawn up properly so as to exhibit a true and correct view of the enterprise as a going concern.

An audit should not entail the original preparation of the Balance Sheet; it should contemplate something much wider — the verification of a Balance Sheet prepared by others, together with the books, accounts, and vouchers related thereto, so that the auditor can certify honestly, in his opinion, such Balance Sheet is drawn up properly to exhibit a true and correct view of the state of affairs of the particular undertaking in question.

The above comment should not be taken as intimating that an auditor's entire duty consists of comparing the Balance Sheet with the books to ascertain that it agrees therewith. This must be done, but such skill and diligence should be exercised that he is satisfied the books record the concern's financial transactions properly so far as information and explanations are available to him. This involves a scrutiny, more or less detailed, of the entire block of the undertaking's transactions for a certain period, in-

clusive of the manner in which their record was made. Just how far an audit must extend depends upon the circumstances encountered in each particular assignment, and this must be decided by the vigorous exercise of the auditor's judgment. In any event, the audit made should be such as will satisfy the auditor under the conditions embodied in his instructions.

Relation to Accounting. — Accounting is a science, auditing an art, and accountancy a profession. Auditing is a branch of accountancy but its scope is much broader than accounting; an efficient auditor must have a thorough knowledge of accounting principles and procedure. Nevertheless, accountants and auditors usually are one and the same persons.

Some years ago a professional accountant's work was concerned primarily with checking the arithmetical accuracy of transactions entered in books of account, agreeing the Trial Balance, and preparing the statements. All this activity may be described as "accounting." At present, it seems that the most important part of the work of a professional accountant engaged in general practice is "auditing." The average individual cannot differentiate clearly between accounting and auditing, inasmuch as it is assumed generally that the preparation of statements by a professional practitioner automatically guarantees the fact that they are accurate. Seemingly, this is not at all the case.

If an accountant is instructed definitely to prepare the usual statements from a set of books, his work comprehends agreeing the Trial Balance, and then preparing the Balance Sheet and Profit and Loss Statement. In this instance, he functions merely as an accountant, not as an auditor. The books are not checked and scrutinized except as necessary to agree the Trial Balance, and the condition shown by the Balance Sheet should not be certified to as correct; the most that could be stated truthfully is that the Balance Sheet agrees with the books. Frequently, accountants are called upon to do work of this kind, but when thus done, care should be observed to show the client an audit is not being made. Further, a Balance Sheet should not be certified as correct unless a proper audit has been made.

Again, auditors often prepare the Balance Sheet and the Profit and Loss Statement, after which they are certified. Nevertheless, in preparing these, the auditor is acting as an accountant, not as an auditor; such work is both in addition to and outside of the scope of his duties as an auditor. An auditor's duty should be to examine and report upon the work of others that has been completed.

Audit Purposes and Advantages. — These being practically similar, they are considered together, but are divided into two classes:

1. Major. These purposes may be differentiated dependent upon the parties who are interested in the audit of a business:
   a. Parties on the inside. A properly prepared audit report points out over-optimistic tendencies in asset valuation, depreciation provisions, liability existence, etc. Frequently, the auditor is able to offer suggestions which, if followed, will promote greater efficiency in the organization. Again, the executives (managers, officers, directors) secure a report from an unprejudiced person covering a verification of the accounts, inclusive of the then financial condition and the period's operation results. Other values to the organization itself include the use of the audit report for the preparation of governmental reports, credit agency reports, and reports covering proposed sale or change in organization; for assisting in the bonding of employees, in the securing of credit, and in the settlement of claims for loss due to fire, flood, etc. In the dissolution of a partnership, the professional auditor should be depended upon to follow strictly the firm articles plus the members' intentions therein expressed, so that the proper status of each partner as to salaries, drawings, and profit division may be stated fairly. Since a special partner in a limited partnership has no right to interfere in the active management of the business, an audit seems absolutely necessary to safeguard his property rights. In the sale of a business, certified statements properly prepared over a period of years reveal the truth as to profits year by year so that a few large years will not knock awry the natural trend thereof; further, the exact truth concerning financial condition year by year is available, and this prevents undue inflation of values frequent when a sale is contemplated.

b. Parties on the outside. Corporate stockholders will feel that their interests are reasonably protected, if they receive a Balance Sheet certified by a reliable practitioner. A clear understanding of the affairs of a business may be secured by bankers who are considering the discount or purchase of its negotiable paper; since a prospective borrower's personal opinion of the condition of his business is apt to be biased, it should be worthless to a banker. Investors finding a certified Balance Sheet as part of a prospectus, will feel that the facts displayed concerning the particular business are reliable. Even the general public may acquire a friendly feeling toward a business which has nothing to hide.

2. Minor. These contemplate the detection and prevention of fraud or errors; if any frauds or errors exist, the carrying out of the main purpose of the audit should uncover their presence.

Fraud in Accounts. — In the earlier days, it seems that an auditor was employed primarily when fraud was suspected by the management; he was looked upon as a sort of detective, his appearance in an office being notice that someone of the staff was under suspicion. To-day, fraud is only a minor reason for an audit, even though detected frequently; seldom is an audit made for the sole purpose of discovering fraud. Coincident with this minor purpose is the prevention of fraud through the moral effect of an audit; for example, a continuous audit (see *post*) frequently prevents an embezzlement, since those who may think of perpetrating such an act know that it will be uncovered.

Although the above view apparently concurs with current American opinion among practitioners, the general public and the majority of clients apparently look upon the principal function of an auditor as the discovery of fraud; hence, even though of minor import, no question exists but that this phase of the matter still is of considerable consequence.

Fraud may consist of:

1. The misappropriation of money or goods, or
2. The manipulation of accounts to deceive stockholders, bankers, creditors, etc., unaccompanied by misappropriation.

The opportunities for misappropriating money or goods are so frequent where persons concerned with the acounting procedures in a business are not subjected to any form of internal check, or to a poor one, that no concern subject to this criticism could be operated long without the possibility of fraud taking place. Where the proprietor of a small business is in constant touch with all the operative details thereof, and is able to supervise effectively, the chance of concealing a fraud may not be very pronounced. On the other hand, as soon as the proprietor, for some reason or other, no longer is able to do this, defalcation troubles are prone to arise unless a proper check is introduced to be maintained by the office staff, or unless the visit of an auditor becomes periodical.

Misappropriation of cash may be concealed in two general ways — by failing to enter receipts or by entering fictitious payments; the first seems more difficult to detect than the second. The amount of detail checking necessary before the auditor can satisfy himself no fraud exists depends greatly upon the system of internal check in operation. To discover the first, the auditor checks receipts *with original records* covering — as counter sheets, sales sheets, agents' returns, etc. Fictitious payments may be uncovered by a careful scrutiny of such documents, original in character, as vouchers, invoices, payrolls, etc. The misappropriation of goods apparently is more difficult to detect than the usual cash peculations, unless accurate stock records are in evidence; without these, small misappropriations of goods are almost impossible to discover. Even though stock losses may be indicated by fluctuations in gross profit percentages, the fraud itself cannot be located by this means.

The falsification of accounts, without actual misappropriation, is of less frequent occurrence than the frauds mentioned above; but when encountered, it is apt to involve large amounts and usually is much more difficult to uncover than the other kind. Generally, this method seems to be used by managers or directors who desire to present a false condition so that some particular group of persons will not lose confidence in the undertaking — as stockholders or the general public; again, it may be caused by the desire to pay dividends, no profits existing therefor, to secure further credit, to evade the income tax, to increase commissions

b. Parties on the outside. Corporate stockholders will feel that their interests are reasonably protected, if they receive a Balance Sheet certified by a reliable practitioner. A clear understanding of the affairs of a business may be secured by bankers who are considering the discount or purchase of its negotiable paper; since a prospective borrower's personal opinion of the condition of his business is apt to be biased, it should be worthless to a banker. Investors finding a certified Balance Sheet as part of a prospectus, will feel that the facts displayed concerning the particular business are reliable. Even the general public may acquire a friendly feeling toward a business which has nothing to hide.

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due themselves, to dispose of their company interests at high prices, etc. Inasmuch as this type of fraud is perpetrated by responsible and trusted company officers, it is most apt to be skillfully covered; undoubtedly, at every attempt of the auditor to advance his deductions, he will be given explanations and information intentionally false. Only by the exercise of great care and skill, and by making most exhaustive inquiries, may he hope to unearth such frauds.

Detection of Errors. — It would seem that an auditor's primary duty is to uncover errors, inasmuch as these distort the actual facts if not detected. The auditor should distinguish without difficulty between the various classes of errors possible on a set of books. Often what seem at first blush to be merely clerical errors eventually are found to be due to fraudulent manipulation; hence, however slight, the cause of every error should be examined into carefully even though, in general, one may assume the majority are due to ignorance or to carelessness. Errors may consist of:

1. Errors of principle
2. Clerical errors
3. Errors of omission
4. Errors of commission
5. Offsetting or compensating errors

Errors of principle occur when transactions are recorded in a manner fundamentally incorrect according to accounting theory; they may be committed purposely or accidentally. They are most important as a class and may affect the accounts considerably; for their detection, the auditor should exercise the utmost care. If made intentionally, they may amount to falsification; but they may have been made unintentionally as well due to a lack of knowledge of correct accounting principles. Minor errors of principle may have no effect upon the final profit outcome, as where they arise from posting to a wrong account within the correct group thereof — as factory office expense to sales office expense, auto equipment to machinery, etc. Major errors of principle have a direct effect upon profits as reflected in the surplus, or upon the proper statement of asset and liability values in the Balance Sheet; they arise from

capitalizing a revenue expenditure or vice versa, from valuing an asset upon an incorrect basis, from inadequate provision for depreciation and bad debts, etc. In order to discover such errors, the auditor should have an extensive knowledge of accounting, and should make a most thorough audit. Ordinarily, routine checking will not uncover errors of principle; only intelligent inquiry, analysis, and research discovers them. Frequently, it is difficult to convince the management they exist.

Clerical errors are common, but few books of account being free from them. They may represent items posted as debits instead of as credits or vice versa (as to these, the Trial Balance is out double the amount in question), transpositions of figures (causing the Trial Balance difference as to these being divisible by nine), carrying forward totals from one page to another in error, posting a debit to one account (as a customer's account) when it should have been posted as a debit to some other account (as another customer's account, etc.), etc. It is seen that certain of these errors affect the agreement of the Trial Balance, and must be eliminated before the latter can be placed in balance; others have no effect upon the Trial Balance and, even if not detected, may not cause the profit to be in error, or the Balance Sheet to be generally incorrect. Care should be used to see that an apparent clerical error is not really fraudulent; only experience teaches the necessary discrimination. On the whole, a reasonable test for these errors should be sufficient.

Errors of omission arise when transactions are omitted partly or entirely from the books of account intentionally or unintentionally. Where a transaction is omitted in part, the Trial Balance cannot be agreed; usually this type arises because of the non-posting of items. If an entire transaction is unentered, the agreement of the Trial Balance will not be affected; hence, detection may be a fairly difficult matter. These errors include such items as omitting invoices from the Purchase Record, delivering goods or rendering services but omitting to bill the customer, omitting provision for rent, salaries, interest, etc. Sometimes the balance of a particular account will indicate that an entry has been omitted: a comparison of the Rent account current year with the last may show a difference representing an outstanding current obligation; the examination of creditors'

statements may prove the suspicion that the current purchases are less than they should be. Although the discovery of these omissions forms an important part of an auditor's work on an assignment and he is justified in spending a considerable time in looking for them, in a business where considerable reliance is placed upon internal checks for short-cutting the amount of the detail work that might be done, all errors of omission may not be discovered. On the other hand, if the plan of audit decided upon is complete, and is carried out thoroughly and efficiently, they should all be uncovered. Where a reasonable test for these errors uncovers some of considerable importance, whether or not further work should be done thereon depends primarily upon the hire-contract with the client. Where errors of omission have been made intentionally, serious discrepancies may result in the accounts, and a fraudulent falsification thereof arises.

Errors of commission occur when transactions are recorded incorrectly, wholly or in part; therefore, they may involve errors of principle. On the one hand, the Trial Balance may not be affected; on the other, where partly incorrect, the Trial Balance may be out to that extent. Usually, these errors are encountered in the Journals; their detection may cause considerable trouble.

Offsetting or compensating errors offset or counterbalance each other so that the total effect upon the Trial Balance is one of neutral tendency. They require the most careful attention since they are a dangerous type, and at times difficult to detect, inasmuch as there is no evidence that they exist. The auditor should be certain none are to be found before passing a piece of work as correct. They may or may not affect the profit; if an error of one amount arises in a revenue account and another of equal amount in a Balance Sheet account, the Trial Balance will agree, but the profit will be incorrect.

In general, if some errors are discovered, unless a detail examination is in order, it seems that no need exists of having instructions revised so as to verify every posting, and no necessity arises of verifying every posting to discover such errors. Tests and account analyses carefully made, on the whole, seem sufficient for all purposes.

Economic Function of Auditing. — The auditor may or may not be a regular employee of the concern under review. His

permanent employment in many cases is an unjustified expense; in others, the cost is more than justified. If he offers his services to the public, he is a professional; if he confines his activities to one organization, he is non-professional.

If the auditor is a member of the staff of the company whose books he inspects, his position therein should be such that internal influence and pressure will not require him to certify to practices which his professional training tells him are wrong. However, in spite of the safeguards thrown around him in this respect, such an auditor, being dependent perhaps upon that one organization for his daily bread, may find himself an unwilling party consenting to many practices that are incorrect and sometimes fraudulent. Because of this, in organizations employing a staff auditor, the independent professional practitioner, the Certified Public Accountant or Member of the American Institute of Accountants should be called in from time to time to give his unprejudiced and unbiased approval or disapproval of the work of the staff member.

Auditors of both classes would be unnecessary if bookkeepers could be relied upon always to do their work correctly, and if confidence could be placed in proprietors and managers to present to the public statements which could be considered as correct and honest pictures of business accomplishment.

Legal Regulation of the Profession. — Legislatures have recognized the importance of the auditor's work to the extent that they have done considerable to protect the public against incompetent persons entering this special field; all that remains for the public to do is to take advantage of the protection furnished. In most states the practice of public accountancy now is regulated to the extent that a test is provided so that those who are about to enter the active work of the profession may be examined as to certain educational and professional qualifications.

Those who qualify upon examination secure a license, and a specific title by which they may be distinguished and known from those who are unlicensed. In the United States, such designation is Certified Public Accountant (C.P.A.); in England, Scotland, and Canada one who has qualified to practice under the law is known as a Chartered Accountant (C.A.).

However, since the qualifications in the various states have

not been uniform, the title, at times, had but slight professional value, its worth depending entirely upon where the examination was taken. The remedy provided for this situation was the formation of the American Institute of Accountants which conducts its own examinations, and which has been successful in having most of the states adopt them in lieu of the former local ones. Therefore, at the present time, in the United States, licensed practitioners are divided as follows: 1. Certified Public Accountants. This is a state degree. 2. Members or associates of the American Institute of Accountants. Some have both titles, and others have but one. These licensed auditors have had a stamp of approval placed upon them by high authority; the unlicensed practitioner always is in a questionable position until he has proved his worth.

Auditor's Qualifications. — An auditor must possess certain essential qualifications in order to perform his duties efficiently. As a basic requirement, he should have a complete and thorough knowledge of bookkeeping practice and accounting theory, which will permit him without too much difficulty to apply them satisfactorily to any set of circumstances encountered. Since an auditor, in the course of time, is called upon to audit various systems of account keeping, he cannot examine the accounts thereunder properly unless he is capable of preparing them in the original instance.

Efficiency hereunder comprehends being a complete master of his subject; the lack of this fundamental requirement is the primary reason for inefficient auditing. An auditor must understand thoroughly business as it is conducted actually, so as to be able to grasp the technical details and methods of a particular undertaking whose accounts he is called upon to examine. Inasmuch as an auditor cannot know everything about every class of business prior to his contact therewith, it seems good policy to be able to ask intelligent questions in order to obtain the requisite information to permit of a peculiar transaction being criticized rightly; an honest admission of unfamiliarity tactfully put will gain greater respect than an assumption of knowledge not possessed, lack of which is almost certain of discovery.

A knowledge of accounting principles and procedure alone will not make a person a competent auditor, inasmuch as auditing should contemplate the application of many principles distinct and apart from accounting. An auditor should have considerable legal knowledge, the more the better. He should be a man of affairs — a student of economics, public finance, taxation, industrial conditions, business organization, business administration, banking, corporation finance, efficiency, and office systems; he should possess both character and tact. It should be impossible for him to be led or influenced easily by others since, regardless of the amount of pressure brought to bear, he should do his duty as he believes it ought to be done even though to do so may be opposed to his own interests; the possibility of a current temporary loss should not be placed above the value of securing a reputation for absolute integrity.

Perseverance, method, imagination, and painstaking are traits concerning which too much cannot be said. Considerable work on an audit is somewhat mechanical in nature; nevertheless, this should be done thoroughly and carefully. Again, he must be practical since, when asked for professional advice, it is necessary to appreciate the practical requirements and conditions of the case; this will avoid making recommendations which, although correct theoretically, are not suited at all to the circumstances of the particular business. In this connection, it might not be amiss to suggest that it is no part of an auditor's work or task to offer advice unless solicited; even though at times his advice may be appreciated if given in a tactful manner, it should be remembered that the auditor does not occupy a position from which he can demand that his recommendations be carried out. Of course, if the situation encountered is so deficient that thereunder it is impossible to produce an accurate report, it is necessary for him to comment upon the unsatisfactory state of affairs.

In conclusion, it does not seem out of place to emphasize that an auditor should be gifted with what is known generally as "common sense."

Legal Responsibility of Auditors. — This does not seem to be established definitely. In general, one who holds himself out as being skillful in any trade or profession, and who is negligent in the performance of an act related thereto, not using in such connection the skill attributed to an ordinarily skillful operative,

is legally responsible for such negligence and is subject to suit and penalty for damages for such failure. It seems that this statement applies to an auditor as well as to anyone else. The above indicates that, legally, one is not required to measure up to the standard of the most skillful practitioner but only up to that of an ordinarily skillful auditor. What an ordinarily skillful auditor is depends upon circumstances.

Reasonable care and skill, however, contemplate more than a mere scrutiny of the books, inasmuch as in addition thereto the auditor must exercise reasonable care to determine how closely such books indicate the real status of the undertaking. Generally speaking, the responsibility of an auditor doing work for an individual, a firm, or a corporation is the same. In the case of the individual, there is but one owner; in a firm, the interests of all partners must be protected; in a corporation, the interests of the various stockholders and bondholders must be safeguarded.

Undoubtedly, an auditor will not be held liable personally if he is possessed of the requisite professional skill, and if he exercises this skill in all assignments, taking every reasonable precaution to satisfy himself as to every point encountered before he gives his Certificate of Audit and, where he remains dissatisfied as to any material point to set out his views thereon clearly in his report. He " must be honest — that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true." (*In re* London and General Bank, 1895, 2 Ch. 682.)

CHAPTER II

SCOPE OF AN AUDIT

Expenditures Apportioned between Capital and Revenue. — These two types of expenditure are of vital importance in auditing since they affect both the amount of profit or loss, and the correctness of the Balance Sheet. Complicated situations calling for a quick decision as to whether an expenditure relates to capital or to revenue are so frequent in practice that it is absolutely essential for an auditor to be perfectly familiar with the principles of differentiation. Often the question of whether or not an expenditure is chargeable to capital or to revenue proves to be the stumbling block for many professional practitioners, inasmuch as no specific rules are available covering a universal application.

An expenditure is a cost incurred, capital outlay or current expense, represented either by the disbursement of cash or by the incurrence of a liability. A capital expenditure, in general, relates to the value of assets used as a basis for, or as a source of, earning power; a revenue expenditure represents a charge against the revenue to be produced from the use of that for which the expenditure is made — as cost of operation, of administration, of maintenance, or a fixed charge. Fundamentally, therefore, the problem is whether a debit shall be made to an asset account or to an expense account.

The basic test of a capital charge in a mercantile or manufacturing undertaking, undoubtedly, is whether or not it reflects a net increase in the original value, efficiency, or productiveness of the permanent assets — those in which the business is conducted; asset value should remain equivalent to the amount of the expenditure. Again, as of the date of the Balance Sheet, there should be actual " going concern " value on hand.

Where directly incurred for capital purposes, the expenditure may be verified when either the Cash Book or Purchase Record

is examined. On the other hand, where an expenditure represents workmen's wages entirely or partly employed on property improvements and extensions, but merged in the general account of Wages, the auditor must be careful to make certain the correct amount has been transferred therefrom to the asset account concerned; otherwise, the period's revenue expenditures will be excessive. Before passing such transfer, the auditor should scrutinize the basis upon which it has been calculated, inasmuch as general estimates are unreliable and not sufficient. Wages related to repairs or renewals should be charged to an expense account, not to an asset account. Again, similar treatment should be accorded expenditures on materials which cannot be allocated directly as a capital charge when purchased. Where such expenditures amount to a considerable sum, it would seem advisable for the auditor to secure certificates from responsible officials as to the correctness of the allocations; these certificates should be referred to in his report.

The immediate object of an expenditure may have no connection with the character of the debit to be made therefor; the cost of drying the plaster in a new building under construction may be capitalized, for example, even though such cost was incurred for something which will produce heat; further, under certain conditions, it may be possible to capitalize even the value of a person's experience. Where an obsolete property is replaced, the cost of tearing down the old plant should be absorbed in the account carried therewith, and the cost of erecting the new one should be sent into a new account established therefor. The balance in the old plant account, less the scrap value involved, represents a loss to be written off against revenue either at once or over a period of a few years.

In many instances, the practices of distinguishment by no means are uniform, except perhaps in the public utility fields where regulative commission bodies require strict uniformity in the treatment of items. In other organizations, the handling of a particular problem is most apt to be left to the individual auditor on the assignment.

Too much emphasis cannot be placed upon the need for a careful consideration of circumstances calling for the differentiation between capital and revenue charges. Every item and

total encountered by the auditor in his work should be viewed with suspicion, be inspected and inquired into to determine actually what has occurred. When his assignment is completed, he must be certain in his own mind as to the amount of surplus as adjusted by him, and as displayed in the Balance Sheet as corrected by him.

Internal Checks. — Because a great amount of time may be consumed in making an audit of even average size, the auditor feels justified in short-cutting portions of the work, particularly that concerned with the detail checking. But just how much detail checking he should perform before satisfying himself that everything is in order depends to a considerable extent upon the system of internal check in operation.

An internal check arises where the work of each employee bears such a relation to that of another that a continual internal audit exists; more than one employee is responsible in recording a transaction completely. Where the internal check system is satisfactory, collusion between two or more persons must occur before fraud can remain undetected. Collusion occurs from time to time rather than frequently since, as a rule, where a second person is approached to become a party to a contemplated fraud the latter is apt, even though not inherently honest, to decide that it is more to his advantage to report the incident and secure the reward of a supposedly honest servant rather than run the risk of discovery incident to being a party to a fraud. Hence, the necessity for collusion is an excellent safeguard, and one upon which the auditor should rely to a considerable extent. Internal checks do not eliminate fraud entirely, but they make it difficult to carry out and the chance of detection much greater; therefore, such a system acts as a valuable moral check. The auditor should not assume everything to be in order just because he believes a satisfactory system of internal check is in operation and, as a result, omit entirely the detail checking procedures; he should test the transactions as exhaustively as conditions seem to justify, and should he find irregularities, he should attempt to have his instructions altered, if necessary, to include a complete examination. His method of approach will contemplate an attempt to find the weak spots in the internal check, and, for the most part, concentrate his

efforts thereon; he should satisfy himself, also, that the internal checks actually are carried out, doing so by test-checking here and there haphazard.

The more an auditor can rely upon internal checks, the more he can get away from a large part of the detail work, and thus the more time he will have available for matters of major audit import. The extent of this reliance thereon, with its resultant omission of checking the whole of the detail entries, depends entirely upon the set of circumstances surrounding the particular assignment; this question must be decided by each auditor for himself. The accuracy of such decision depends upon his skill, experience, and judgment; the efficiency of the audit depends largely upon the skill with which this problem is handled.

A proper internal check can be secured only by adopting such a system as guarantees:

1. That no portion of the accounting work will be done under the absolute and personal control of any one individual.
2. That the activities of one employee will be complementary to those of some other employee.
3. That the handling of all money will be safeguarded, this applying particularly to such transactions as cash sales, payrolls, discounts, freight, etc.
4. That the incoming and outgoing goods will be handled properly and accounted for:
   a. All goods paid for must be received.
   b. All goods shipped must be charged to customers.
5. That, in general, the employees will check each other's work in such a way that the details of the business are under continual audit.

Although the internal check components of each case under review differ one from the other, the following general points must be provided for carefully:

1. As to cash:
   a. All cash received, cash or checks, must be deposited in bank — as daily.
   b. All cash payments, when possible, must be made by check and every such payment supported by a properly authorized voucher.
   c. All small payments in actual cash must be made from a petty cash fund operated on the imprest basis.
   d. The cashier shall not have access to any of the individual Ledgers or to the statements sent customers.
2. As to purchases. All goods or expenses purchased must be evidenced by a vendor's or creditor's invoice. These must be checked as to additions and extensions, be duly approved as to quantity and quality by persons receiving goods and as to price by those who authorized the purchase. Next, these must be approved for payment by the one in charge of the accounting department, after which they should be turned over to someone else (as treasurer) for payment.
3. As to sales. All sales invoices must be checked as to extensions and additions at least once before being sent out to customers. If possible, a copy of the sales invoice to be retained should be made out at the same time the original is prepared, this being the first carbon copy thereof, and together such carbons forming the Sales Book or Sales Register. By so doing, an exact copy of the invoice sent out is secured which is good evidence of the fact that the actual sending took place.
4. As to Ledgers:
   a. The General Ledger should contain a controlling account with each subsidiary Ledger.
   b. Each subsidiary Ledger should be balanced monthly against its General Ledger control.
   c. Trial Balances drawn from the Sales Ledgers should indicate the age of all accounts past due.
5. As to miscellaneous matters:
   a. All incoming mail should be so handled that the cash therefrom received will be accounted for in full.
   b. The payroll system should prevent padding, and provide for the detection of errors in time, rates, and extensions.
   c. A yearly vacation must be taken by each member of the office staff so that in his absence a stranger will be required to do the work of the absent employee.

The First Audit. — Before commencing a new audit assignment, the auditor should determine from the instructions given him by his employers exactly the nature and scope of his duties. Inasmuch as there exists frequently in the minds of clients a

vagueness as to what constitutes the scope of the work of an auditor, the latter should protect himself by having the requirements of the case set out in writing and agreed to by the client; particularly does this seem true where the audit is not to be a complete one. The contents of such a letter of engagement confirmation are illustrated by the following:

Syracuse, New York,
December 28, 1923.

Hancock Manufacturing Company,
1920 Water Street, City.

Attention: Mr. J. B. Hancock, President.

Gentlemen:

This letter confirms arrangements agreed to by you in our conference held at your office December 27, 1923, relative to the audit of the books and records of the Hancock Manufacturing Company, for the year ended December 31, 1923.

This audit will consist of:

1. A verification of assets to determine that they are all accounted for and valued properly;
2. An examination of liabilities to determine if all obligations in existence have been incurred properly and are displayed correctly;
3. A reconciliation of profits to ascertain if the Surplus account is stated properly.

Insofar as seems expedient, we shall go back into the records for a period of two years, this being the time during which the Hancock Manufacturing Company has been in existence.

Our Mr. Fox will be at your office on January 7, 1924, to commence the audit.

The audit report will be addressed to Mr. J. B. Hancock, President, and will reach him not later than March 1, 1924.

For services rendered, the fees charged will be:

Senior in charge	\$35.00 per diem
Each assistant required	20.00 " "
Supervision by firm member	50.00 " "

In addition, whatever expenses are incurred by us on your behalf will be charged to the Hancock Manufacturing Company.

Yours very truly,
I. WORK
WORK & DOMUCH

Next, he should become acquainted thoroughly with the exact nature of the undertaking, and with the technical details of its transactions. In connection herewith, it seems to be advisable to be shown through the plant in such a manner that the various processes and divisions may be encountered in logical sequence. The knowledge secured hereunder enables him to obtain a much more complete grasp of affairs, and appreciation of essentials, than would be the case if his activities were confined only to the limits of the office.

Further, if he deems it advisable, the auditor should prepare a list of all the books of account, with the names of those in charge of each, their office titles, duties and authority. Following this, the entire system of accounts and the internal checks should be investigated, even to the point, at times, of securing a written statement regarding the latter. Only after this has been done, is he in a position to lay out an adequate plan of procedure. Even on a repeat case he ought to determine first whether or not any change has occurred in such system during the interim subsequent to the last examination.

He should endeavor to see that the system is such that every transaction becomes recorded properly in the books of account, that no possibility exists of items being omitted or altered accidentally or on purpose, and that no fraudulent entries can be made without automatic detection.

Only by approaching the problem somewhat as above will the auditor be in a position to visualize the principal lines along which the audit will develop; the structure of his audit plan should bear a direct relation to the system of internal checks uncovered.

In order to illustrate the above, assume a manufacturing concern; the particular points to which the auditor should direct his attention may be as under:

1. How is cash received and paid out?
2. What are the duties of the cashier relative to books of original entry other than his Cash Books?
3. How are the payrolls prepared and wages paid?
4. What is the procedure for handling invoices received, up to point of payment?
5. How is petty cash handled and controlled?

6. How do entries reach the Customers' and Creditors' Ledgers, and how are the balances therein checked and agreed?
7. How do the Ledger clerks secure the control figures against which they must check?
8. Etc.

Further, all legal documents relating to the activities of the concern should be studied carefully and notes made of clauses likely to affect the accounts with which he should be familiar as the work progresses.

Vouchers. — In auditing, these represent all documents confirming entries made upon the records. Naturally, every entry upon a set of books should be supported by a properly approved voucher. It is noticed later that the work of examining vouchers and of comparing the book entries therewith constitutes the major portion of what is considered frequently to be the mechanical work of an audit — that falling primarily to the lot of the junior assistants.

Principle of Charge and Discharge. — In general, an auditor is concerned constantly with responsibility and accountability as related to:

1. An entire business establishment. Certain values flow into a business and certain others are going out from a business constantly. These consist of:
   a. Cash
   b. Paper obligations (checks, notes, contracts, orders, drafts)
   c. Supplies (stationery, postage, fuel, etc.)
   d. Depreciation of tangible assets

   If one, theoretically, personifies a business, it is not difficult to comprehend that the auditor must determine (concerning transactions with outsiders):
   a. As to incoming values, the charges and chargeability
   b. As to outgoing values, the discharges and dischargeability
2. The various organization units within a business establishment:
   a. Departments
   b. Persons

   The transactions hereunder are either departmental or those flowing from one person to another. The auditor must examine these, keeping in mind that, concerning the business as one complete unit, transactions may not represent charges and discharges; although important from the viewpoint of accounting and auditing, total wealth may not be changed thereunder.

The type of audit in contemplation, considered later, determines how much verification the auditor will make as to responsibility and accountability of:

1. The whole business
2. Departments within the business
3. Persons within the departments

Detailed Audit. — The average auditor all too often ignores the matter of chargeability, feeling that his task is sufficiently accomplished if he verifies only charges; hence, the ordinary audit as made is decidedly incomplete, inasmuch as:

1. Only recorded transactions are verified.
2. The audit does not determine whether all items that should be on the books actually are there.

High caliber professional work contemplates much more than the average type of audit.

In order to make an audit, it is necessary to select some starting point so that the auditor may verify intelligently:

1. Values which have come into the business
2. Values which have gone out from the business

This cut-off point may be said to be:

1. The date upon which the enterprise began, or
2. Some later date

The detailed (or complete) audit is the ideal one. Seemingly, it commences at a specified past date and ends on a designated later one; hence, it contemplates the verification of all income and expenditures between two specific dates. In general, the auditor accepts as correct certain figures representing account balances as of the first date agreed upon, and then verifies the actual charges and discharges during the period down through and inclusive of the specified later date, completely checking

all records, footings, postings, vouchers, etc. But inasmuch as the auditor should determine the truth or fallacy of the facts so-called coming under his notice, under suspicious circumstances, he must scrutinize the records and documents available as far back as is deemed necessary and expedient. Therefore, under a so-called detailed audit, limited supposedly as to starting point, it is necessary frequently to go back into figures of a date earlier than that of the agreed-upon point of commencement. The auditor's conduct in this respect usually is governed by the terms of his hire-contract; because of the limited fee involved in a given case, it may be necessary first to communicate with the client, laying before him his suspicions and asking authority (and an added fee) to act otherwise as to the period to be covered in the original hire-agreement.

Only under the detailed audit may it be stated that the actual charges and discharges of a specified period are verified. In connection herewith, the auditor applies a formula stated somewhat as:

Values at beginning of period (per Statement of Condition or Balance Sheet)

plus

Values coming in during the period (charges)

less

Values going out during the period (discharges)

equals

Values at end of period (per Statement of Condition or Balance Sheet)

Since the verification of every entry and transaction is infrequent, the detailed audit seldom is used:

1. The efficient auditor's time is an expensive purchase; hence, only rarely is a client found willing to pay for absolute completeness.
2. The detailed audit, practically, contemplates the duplication by the auditor of all the bookkeeping work already done; naturally, in so doing, an unreasonable and impractical amount of time is consumed, especially where a satisfactory internal check is in operation.

The natural conclusion, therefore, is that the auditor must decide what portions of the work require minute inspection and what sections may be covered with a lesser expenditure of effort. On this point, his determination should be the result of:

1. Technical correct judgment as to the weak and strong spots in an organization's system of internal check
2. The system of accounts in use within the particular establishment

Balance Sheet Audit. — The substitute evolved in place of the detailed audit is known as the Balance Sheet audit. This seems to be entirely an American product developed to a remarkable degree probably because of the emphasis American business has placed upon the matter of internal organization. The better the internal organization, the less is the need of a detailed checking, and the more may be the reliance placed upon a testing process — picking out and verifying a number of transactions of the period being reviewed. If these selected transactions are found to be correct, the whole collection for the entire period is assumed as having been handled satisfactorily.

The Balance Sheet audit:

1. Verifies the assets and the liabilities as on a specific date.
2. Contemplates an analysis of the profit and loss accounts sufficiently exhaustive so that the auditor is satisfied the Surplus set out in his Balance Sheet is reasonably correct.

In the verification of one particular Balance Sheet or post-closing Trial Balance, the scope of this type of audit may be shown:

1. As to assets thereon:
   a. Determination of actual possession thereof as on Balance Sheet date
   b. Determination of whether valuations thereof were conservative
   c. Determination of existence of other assets not thus shown
2. As to liabilities thereon:
   a. Determination of actual and proper incurrence
   b. Determination of full inclusion of all
3. As to surplus:
   a. Analysis to determine that proper capital and revenue distinctions were made in the accounts

From the above, it is noticed that the Balance Sheet audit does not contemplate the close application of the principle of charge and discharge, since it does not wholly represent an audit of values coming in and going out between two set dates. Practically, however, a clear line of separation does not seem to exist between these two kinds of audits. The auditor must reach a certain conclusion to which he is willing to certify and in order to do so he must make use of whatever procedures he deems necessary to enable this to be done; hence, in many ways, in practice, the two seem to shade into each other. This blending occurs at such variable points in particular assignments that it seems illogical, if not impossible, to formulate a particular set of rules to be followed in every case. A careful study and scrutiny of what follows in this book cannot do more than indicate general scope and nature. Only experience enables one to discriminate in making a particular audit.

On the other hand, however, a certain standard has been set for the making of a Balance Sheet audit in a bulletin of the Federal Reserve Board titled "Approved Methods for the Preparation of Balance Sheet Statements." This was the first publication of its kind attempting to set forth a reasonable responsibility as contemplated in a Balance Sheet audit. One may state without much fear of contradiction that an auditor may do considerably more on a particular assignment than is contemplated in this publication — which has the approval of the American Institute of Accountants — but he should reach at least the standard therein indicated. Because of such fact, a copy of this bulletin should be in the hands of every auditing student and every accounting office. Not only does it set a standard for Balance Sheet audit procedure, but it is extremely valuable as a document against which to check an audit plan after the latter has been prepared so as to avoid overlooking some point therein.

To recapitulate: If inquiry by the auditor develops the fact that a satisfactory system of internal check prevails in the particular organization to be audited — by means of which the work of one employee is verified and approved by another — this internal check may be relied upon somewhat as substantially guaranteeing routine accuracy. Hereunder, a Balance Sheet audit is in order by means of which the assets are verified as to existence, ownership, and reasonable valuation; by means of which an attempt is made to have all liabilities shown upon the corrected Balance Sheet, based upon proper incurrence; by means of which operations are examined sufficiently so that the auditor is assured profits have been stated with reasonable accuracy. Further, being satisfied with the sufficiency of the system of internal check, the Balance Sheet audit is presumed to guarantee the client a reasonable assurance that he is protected against the possibility of defalcations. On the other hand, if the internal check system is not adequate, a detailed audit is preferable.

Sundry Kinds of Audits. — The terms with which one may come into contact, used to describe particular types of audits and the general scope of the auditor's work thereunder, are somewhat numerous and, frequently, the meanings do not seem to be as clear as one would desire. Briefly, in addition to the two general classes or kinds of audits mentioned above, those summarized below may be encountered; note the tendency, from time to time, of an overlapping in meaning. In any event, an audit may be carried out either continuously, at specified or unspecified interim dates, or entirely after the period under review is ended:

1. Completed or final audit. This is understood commonly as one not commenced until after the books are closed at the end of the fiscal period, and then carried to completion by a continuous procedure. The scope of the audit seems to be that of a detailed audit, a most satisfactory type particularly in the case of small concerns; in large undertakings, however, the amount of time consumed by the audit is so considerable that the audited statements cannot be prepared within a reasonable time after the period's close to be of advantage to the enterprise.
2. Periodical audit. This seems to be synonymous with "completed audit."
3. General audit. Apparently, this term is not in common use; undoubtedly, it refers to a general going over of all records for a certain period of time; hence, it seems to refer to a detailed audit.

4. Payroll audit. This relates to an audit of all the activities concerned with payrolls. Its extent depends upon the system of internal check. All payrolls should be certified to by the signatures of the officials responsible therefor. Cancelled checks covering wages and salary payments should be tested carefully against the payrolls; payroll footings should be verified; employment cards should be used to vouch the payrolls; the Directors' Minutes should be scrutinized.
5. Cash audit. No such audit really exists, in the true sense of the term "audit," since an audit limited only to the cash records cannot be anything but incomplete and unsatisfactory. If the above criticism is not applicable to a particular assignment completed, then the auditor has scrutinized records other than cash records which are complementary to the Cash account. If applied to the audit of a cashier's accounts, as to those of a treasurer of a corporation, the cash records *and supporting documents, papers, and books* must be examined; the purpose is to determine if there has been any error or fraud in handling cash. This would be, however, an investigation rather than an audit.
6. Annual audit. Any audit made annually is an annual audit. It would seem, however, that a detailed audit conducted annually is comprehended by the term.
7. Complete audit. This is a detailed audit. It may be a completed (periodical) audit or a continuous audit.
8. Continuous (interim) audit. This is a detailed audit executed either by having the auditor's staff occupied continuously on the books during the entire year, or by having the work done piecemeal — at intervals during the accounting period and just after its close. In the latter instance, the audit is periodic to the extent of being monthly, quarterly, or semi-annually. As to each portion of time covered, during the fiscal period, a report of progress is made rather than but one final report which is reserved for the end of such period. A continuous audit seems adaptable to a situation particularly in which the work involved is considerable. Its advantages over an audit commenced after the close of a fiscal period are:
   a. More detail checking can be performed.
   b. Errors are discovered and corrected more promptly; in the event of fraud, the early discovery gives the person guilty thereof less time to operate with the result that the amount involved may be much less than would have been the case had the audit not been commenced until after the close of the financial period.
   c. The accounting department is kept on the *qui vive* to have their work caught up currently and correct.
   d. A closer relationship is created between auditor and client than is possible where an audit is made only yearly or infrequently.
   e. The audit can be completed more quickly after the period's close than otherwise would be the case.
   f. Current operation tendencies are brought to the attention of the management before too long a time has elapsed.

   Nevertheless, certain marked disadvantages should be remembered:
   a. More of an auditor's time is apt to be consumed than otherwise might be the case; this means increased audit cost.
   b. A possibility is presented of having figures altered, after having been checked and passed by the auditor, either innocently or fraudulently.
   c. Inasmuch as such an audit is not carried through to completion at one time, it is possible for the auditor in charge to lose the thread of a certain portion of the work related to transactions left open at the time of the last visit.

   These various disadvantages, however, may be guarded against in such a manner as to minimize their effect. To this end, the following is suggested:
   a. No alterations in figures should be permitted, once the auditor has passed them, and special tick marks or notes should be used covering figures erased or otherwise altered so that on later visits it may be noted readily that the new figures are those actually seen.
   b. In order to prevent juggling figures in the General Ledger after the auditor has checked them, two courses of procedure seem open:
      i. Where the General Ledger work is not voluminous, it may be advisable to forego doing such until the final

Trial Balance is drawn and the books closed. This would mean that the interim activities comprehend vouching the cash, footing subsidiary records, work on the Customers' and Creditors' Ledgers, etc.

ii. Where the General Ledger work cannot be left until the end of the period, all account totals should be drawn off up through the date of each checking so that these may be verified at the next visit to determine that no manipulation has occurred.

c. If an auditor has a staff of sufficient size to warrant it, no one operative should make two consecutive audits of the same business.

d. The contact with the auditor's office should not be so frequent that the latter is in touch continually with the variations taking place within the client's business; otherwise, procedures will not be applied as carefully as if the client were a new one. Perhaps it is not going too far to suggest that, although the continuous audit has specific value, it should not be necessary more than quarterly.

Regardless of the method by means of which the continuous audit may be approached, the auditor should exercise great care and supervision in the conduct of the work, and should be aided by the judicious use of notes as necessary.

9. Special examination (investigation). These are carried out to secure particular information which a client desires, according to the nature of the hire-contract. The following types are representative, as in connection with:

a. Sale or purchase of a business
b. Suspected fraud
c. Retirement of a partner
d. Securing information required by:
   i. Creditors, prospective creditors, stockholders
   ii. Parties to disputes or litigations
e. Consolidations and reorganizations
f. Etc.

Specific Responsibility under Varying Audit Conditions. — The liability and responsibility of an auditor should be limited both by the nature of the particular assignment and the

instructions received from the client. If his possible actions have been circumscribed by limitations, he should follow the instructions received; however, if in the course of his work he has reason to believe or suspect that errors exist outside the scope contemplated by his orders, he should report his conclusions thereon and request further instructions.

In case he is to work without limitation, in a detailed audit he should assume full responsibility. In the event of a Balance Sheet audit, his certificate should contain no qualification beyond that which relates to the Surplus account as part of net worth; it should be shown that no detailed audit of operations was made. In order to grant a Certificate of Audit under unlimited instructions, he must satisfy himself as far as possible that his deductions are correct, that the adjustments to bring the records in agreement therewith are as they should be.

Frequently, an auditor secures a client who has had his books audited in the past by another. Hereunder, the question arises as to the stand to be taken by him as to the work done by his predecessor. In the absence of instructions to the contrary, it would seem that he should accept the correctness of the other's work, provided he is satisfied that this person was competent; otherwise, he is justified in reviewing the former's work.

Classes of Professional Auditors. — Practicing accountants operate either as individuals or partnerships; the corporate form of organization for an accounting office is frowned upon by the profession at large, and undoubtedly would be by legal opinion (" The legislature in authorizing the formation of corporations to carry on 'any lawful business' did not intend to include the work of the learned professions." See *Re* Co-operative Law Co., 198 N. Y. 479). Seemingly, the partnership form of organization is preferable since two minds are better than one in reaching a satisfactory decision upon an important matter. The larger accounting firms have the following classification of operatives, as a rule:

1. Partners (principals)
2. Supervising or managing senior
3. In-charge accountants (seniors)
4. Semi-seniors
5. Juniors

On the other hand, the smaller firms classify their operatives as:

1. Partners
2. Seniors
3. Juniors

One who begins work upon a professional staff does so in the capacity of a junior (a beginner). At first, the junior usually is given clerical duties around the office in order to become acquainted with firm policies and practices. Later, he is assigned to toil under the direction of a senior who is familiar with field operations, and by him he is instructed in detail as to just what to do and how to do it. In the course of time, the junior receives but general instructions from the senior, who may or may not then go with him on a case, and he is expected to know how to handle the work thus assigned. Still later, according to development, the junior may be given small assignments to work out by himself; if he is successful in this, he may be known as a semi-senior. The entire matter of promotion, one stage to another, depends upon his winning the confidence of the members of his firm sufficiently to be given tasks of increasing importance.

Basically, a junior's duties vary in accord with his training and ability; they contemplate work in connection with all or most of the following:

1. Counting cash, notes, and securities
2. Verification of bank and cash balances, notes, and securities
3. Reading Minutes (at times)
4. Drawing Trial Balances (at times)
5. Checking footings, postings, inventories
6. Testing postings
7. Vouching entries
8. Preparing account analyses and schedules

Each senior may have one or more juniors under his supervision depending upon the nature and extent of the case in hand. He is expected to plan their work and direct them in its execution. He decides the difficult questions that arise, unless so complex in nature that contact with the home office first is necessary. He makes a complete report of each case as finished,

accompanied by the working papers thereon properly arranged which show in detail what he has done and the conclusions drawn. At times, he may prepare the final report that goes to the client although, should this be done, the report would be reviewed later by one of the members of the accounting firm.

The Engagement or Case. — Before an assignment is accepted, the auditor should determine the legal responsibility of the prospective client toward the case in hand; and for reasons already given, it is advisable to secure a definite written contract covering the work to be done.

It is customary for auditors to use an Engagement Blank for each assignment so that the particular stipulations thereof will make an intelligent contact possible. In order to determine what work must be done, it is necessary to know what has been contracted for by the client. One form of Engagement Blank is illustrated *post* in Chapter 15. Although variations are encountered, all facts connected with the agreement made with the client should be shown. Further, the auditor should carry a copy of the blank with him on the case.

Next, before going out on an engagement, a letter of introduction should be secured. A proper introduction is necessary before a member of the auditor's staff will be permitted to walk into an office and begin an audit of the books and records. Further, if an out-of-town case is in hand, time reports, expense reports, expense funds, railroad and Pullman tickets must be secured. Finally, in the matter of equipment, analysis, Journal (and Ledger) paper are needed (analysis paper — probably 14 columns per sheet); black, blue, and red pencils, small ruler and eraser, pen points and penholders, memorandum book, blank bank certificates. All of this equipment, preferably, should be placed in a leather brief case or, in the absence thereof, in a strong envelope carrying both accountant's and client's name and address; the client's name and address may be omitted therefrom.

The auditor's memorandum book or diary is a most important article. In this, a daily record is kept of work done, the time consumed thereon, and particulars of interest; also, expense details are entered in it. Hence, detailed information is available in this book from which both the time and expense reports are prepared. Further, painstaking care in writing up this memoran-

dum record does not represent wasted effort since frequently, at a later date, this diary may be of great importance when the auditor is called upon to testify in Court in connection with which it is necessary to establish what was done on a specific day at a certain hour.

All papers being prepared upon a case at all times should be kept in the personal custody of one of the auditors. This means they are taken with him at lunch and at night, unless circumstances permit their being placed in the client's safe; undoubtedly, the better practice is to keep these in the personal possession of one of the auditor's staff.

Auditor's Attitude and Conduct in Contact with Office Force. — As a basic proposition, the auditor should remember that the interests of the personnel of the client's accounting department are apt to be diversified, and he ought to govern himself accordingly:

1. Certain employees may be interested vitally to have the records hold every possible charge that can be sent against an asset account. In many instances, the income of certain employees is dependent and payable upon the showing of a state of solvency.
2. Certain employees may be interested vitally to have the records hold as few charges against the asset accounts as possible:
   a. These persons, or someone behind them, may desire the spreading of a rumor of coming disaster so that an interest in the concern may be secured at moderate cost.
   b. Other persons, individually responsible for property as represented in the accounts kept by them, may desire to show as small an amount of property in their charge as possible so that they can make way with portions of it from time to time:
      i. Accounts and notes receivable. The smaller the amounts thereof, the less will be the accountability for collections.
      ii. Goods. The smaller the amounts thereof, the more may be appropriated to personal use.

Further, too much emphasis cannot be placed upon the importance of an auditor's personal contact with the client and the latter's office force. Briefly, the following points are illustrative:

1. Be prompt and neat in appearance; wear inconspicuous clothing.
2. Be tactful under almost all situations. Since the adoption of recommendations cannot be forced, tact is necessary to gain important points which will arise. Trivial matters should not be taken too seriously.
3. Be courteous, but do not overreach and become familiar. Eliminate argument and discussion with client's staff, and with brother accountants during office hours. Use the title of "Mister" in addressing all men, so that a quiet dignity may be emphasized. Use correct English under all circumstances; eliminate all slang expressions.
4. Secure coöperation of client's staff. This may be done by showing an inclination to be of help and service rather than by any display of authority. Such coöperation is never attained by conversing freely with members of the client's staff, beyond what is absolutely necessary. Further, do not assume all men are crooks. Relations should be open and above board. When so, there may be but slight difficulty in securing the unqualified right, privilege, and authority to investigate as the auditor deems best. Presumably, the management has granted authority to do the work, but many obstacles may be thrown in the auditor's way by both management and office employees if these feel the auditor uses illegitimate and underhanded practices:
   a. In general, illegitimate information should not be considered as authoritative. Only in rare instances information secured from unauthorized and irresponsible clerks, apparently disloyal to their organization, will prove of permanent benefit. Infrequently, as where an auditor is ordered from the outside to make an examination, and where everyone within resents his presence, may he decide to encourage the receipt of information from all possible sources.
   b. Open and legitimate suggestions from the office force relative to office procedure, should be welcomed, and advantage taken thereof. In no better way, practically, can an auditor familiarize himself quickly with local conditions.

Office authority and responsibility follow the office organization chart. The auditor should secure a copy of this

chart if there is one in existence, and govern himself accordingly, thereby eliminating the chance of possible later embarrassment. At the proper time, instructions will be given by the office manager to place records, memos, etc., at the auditor's disposal.

5. Use discretion in making arrangements for securing the books needed; select times when particular records are apt to be idle, and arrange the work so that the time in between is not wasted.
6. Learn to concentrate upon the work, regardless of location.
7. Be enthusiastic in executing the duties assigned.
8. Exercise eternal vigilance.
9. A junior should ask no questions of the client's staff. He should report only to his senior, and use discretion as to matters taken up with him. Be slow in reporting errors; think before jumping at conclusions. An efficient auditor is a most non-committal individual, ever on the alert to refrain in any way from pledging himself, by implication, to a certain course of action. By the exercise of care and circumspection, the ideal auditor will guard against deceit, error, and surprise. With a mixture of business common sense and professional technique he tests the assets impartially and firmly, with the ultimate object of the audit in mind at all times, and with the idea of safeguarding the interests of his clients at every step. Ceaseless caution and constant watchfulness over himself and over others are of paramount importance.
10. Secure as comfortable a place as possible in which to work, with plenty of light and desk or table space (preferably in a separate room); but one should adapt himself to existing circumstances.
11. Regardless of how painful the attempt may be, be a gentleman.

The junior accountant cannot become a senior in one jump, at least in offices of repute. Ability, tact, appearance, etc., all have a part in one's rise from junior capacity to senior rank. An appearance of ability on the part of a junior is of considerable help in securing a client's confidence; without confidence on his part, unnecessary handicaps are encountered. Nevertheless, actual ability cannot be displaced by mere appearance thereof; hence, the junior should do everything that will secure

for him actual knowledge. He should bend every effort to develop an analytical mind, the ability to criticize constructively, and the power of imagination.

Working Papers. — It is difficult for the auditor to control his work in connection with account verification, examination, and investigation unless he lays his plans most carefully. Even upon a relatively small assignment it is necessary to make an analysis of the content of certain records, to make comments as to conclusions drawn relative to particular elements, to correct and adjust both entries and accounts, and to prepare statements and a report. Therefore, as a matter of protection, it is necessary to have such facts and conditions reduced to writing; these written sheets that accumulate, representing a complete record of the work done upon an assignment, from the facts of which the final statements and report are prepared, are known as "working papers."

The above represents the major purpose of preparing working papers. But since a lesser usefulness exists as well, the following summary is offered:

1. Major purpose:
   a. To justify, support and furnish facts for the preparation of the auditor's final typewritten or printed report on a particular case
2. Minor purpose:
   a. To enable the ready substitution of one accountant for another on a particular assignment:
      i. During the current audit
      ii. At a subsequent date
   b. To permit of intelligible testimony being given in Court, should developments demand such activity
   c. To become the basis of subsequent work for the same client
   d. To be used as a reservoir of valuable information and ideas which may prove of worth in giving all clients a better and more economical service than otherwise would be the case

In other words, an auditor's working papers represent his record of each case upon which he has worked. They are the papers upon which he has accumulated his data concerning a

given examination, and copies of those which are drawn up from the data sheets for inclusion in the final report. The rise of a junior into the first steps of a senior's work is marked by his being assigned the preparation of working papers.

Working papers cannot be prepared too carefully. Undoubtedly, the mental characteristics of an auditor, his ability and ingenuity, are reflected by them. Hence, neatness, care, and lucidity should be observed at all times in their preparation. Further, consistency and uniformity should be followed in making them; this requires thought. Seldom is a set of papers encountered containing all essential information only; usually, they hold too little information (a pathetic situation) or too much (preferred to too little, but still subject to criticism). Experience as an auditor is the only means for reaching the highest state of proficiency in their preparation.

The junior must realize quickly the great importance and responsibility attached to his custodianship of a set of working papers. Careless handling of them is absolutely inexcusable. This applies to the papers prepared by him as well as to those prepared by the senior and intrusted to his care.

Paper Color and Quality — Use of Ink. — Paper used by auditors may be white, buff, or light blue. A distinctive color is advisable so that working papers will not be confused with the ordinary documents and records found in an accountant's office. Further, the color selected should subject the eyes to the least possible strain, especially under electric lights; this is a matter of opinion to be settled by the particular accountant concerned. Further, the quality should be such as will permit the use of ink and the making of erasures.

Working papers should have writing only on one side:

1. To avoid confusion
2. To avoid overlooking material that may be on the reverse side which may result in considerable lost effort

Only one class of data should be placed upon a sheet. The writing may be made in either ink or pencil, depending upon the practice followed. If permanency and legibility be desired above all else, ink should be used. However, there is much to be said in favor of pencil:

1. Utility. Work can be performed more rapidly on the whole than when ink is used, and neatness of appearance need not be sacrificed.
2. Convenience. For reasons unforeseen, portions of a piece of work require changes; hence, erasures are frequent, at least as concerns analyses. It is much easier to erase if work is done in pencil.

A desirable rule to follow as relates to the use of pencil or ink would be as follows:

1. Prepare all preliminary papers, as analyses, in pencil. Here, erasures are necessary.
2. Prepare all summaries, and the draft of the final report, in ink. No excuse exists for erasures in the summary sheets that control the various analyses.

The auditor should not be miserly in the use of paper; he should use paper freely, but not unnecessarily.

In the matter of notations and extracts, an auditor will save considerable time if he can secure exact copies of official documents in which he is interested; large corporations, especially, are apt to have on hand printed copies of the charter, by-laws, stock issue information, information concerning issue and sale of bonds, contracts, agreements, prospectuses, etc. These then may be read at leisure; many will be of such a size that they can be inserted readily with the regular working papers at the proper places in the set.

Working Paper Rulings. — In a general way, every auditing student may be presumed to know something concerning working papers or sheets since, undoubtedly, these were used in his earlier work as an aid in statement preparation. In fact, the same type of sheet may be utilized by the auditor to control his work upon a given case:

1. The figures as shown by the final pre-closing (or post-closing) Trial Balance drawn from the books are transferred to a work sheet.
2. Errors as discovered are posted directly to this sheet by means of adjustment columns.
3. An adjusted Trial Balance is set out thereon.
4. Statements are drawn upon the basis of the adjusted Trial Balance being set out thereon at the right.

5. A schedule of adjusting entries is set up in agreement with these which have been posted upon the work sheet. A copy is given the bookkeeper for entry upon his books so as to place the latter in agreement with the audited statements. All entries used upon the work sheet may not be found in the schedule handed to the bookkeeper since some may not be the result of errors uncovered.

In addition to the main work sheet mentioned above, the auditor uses what may be termed subsidiary work sheets; these hold the detail facts of his audit of the various items set out on the main or control work sheet, each such sheet or sheets being subsidiary to particular items on the main work sheet.

For both types, it is common to use a form of ruling under which the paper is known as analysis paper. This is Journal-ruled except that instead of the usual two columns associated with a Journal sheet there are a large number — anywhere from twelve to twenty-four single columns. Between each group of seven columns, probably excluding the first three and the blank space at the left for account names and folios, is a narrow column which is to be left blank, so that the sheet may be folded without blurring the written work thereon which might result were a fold made elsewhere on the sheet.

Regardless of the number of columns upon each sheet, the latter should fold to a size approximately fourteen by eight and one-half inches which is convenient for placing such sheet flat in a brief case or portfolio (with which every auditor should be equipped), and for binding and filing purposes. If it is desired to use a smaller sheet than the full-sized one, should full-sized sheets be the uniform kind purchased, one or more sections may be detached along one of the folds without a resulting confusion in the basic binding size. This paper may or may not be ruled on the reverse side; if it is, there will be a variety of column groupings on each section of the paper for purposes of convenience. However, it should be remembered that work sheets are written on only one side, never on both. Certain stationery stores sell this analysis paper ruled vertically only to hold amounts in each column in the ten or hundred thousands; since such rulings are of limited use, work sheets should be ruled to hold amounts in the millions. If paper with the latter vertical rulings cannot be purchased, arrangements should be made with a printing shop to have analysis paper cut and ruled to order.

In many accounting offices facts connected with a case often are recorded upon paper other than the regular so-called analysis paper, especially those that do not require much of a technical accounting display:

1. Legal cap or writing paper, ruled horizontally only — for making notations, extracts from various documents, and writing text matter ($8\frac{1}{2} \times 14$)
2. Three-column Journal paper ($8\frac{1}{2} \times 14$, with columns at the right)
3. Cross-section paper — for special statements or statistical set out, graphic charts, etc.
4. Special rulings may be necessary for special work.

Ledger-ruled paper seldom is used since Journal paper nearly always answers for such purposes. Regardless of kind, the size and appearance of working papers should be uniform, at least when folded, the fold being at the right. Uniformity in size and appearance is highly desirable.

Working Paper Content and Filing. — Every component sheet in a set of working papers should be described properly — name of concern (or code number), description of content or purpose, period covered or date for which prepared, and name or initials of person constructing same. This heading is written in prior to laying out the columnar arrangement thereof; frequently, these sheets will be headed up by the senior in charge. If the peculiarities of each situation are studied prior to planning the working sheets therefor, false starts, with their incumbent loss of time and paper, may be reduced to a minimum.

Working papers should be so arranged (and subsequently be indexed) as to be available for quick reference, both currently and at later times. It is presumed most auditors retain these papers after the completion of an engagement rather than pass them over into the custody of the client; at least this seems current practice, regardless of the fact that good grounds seem to exist for maintaining that such papers are the property of the client (although no legal decisions have been found thereon). Whatever method of filing be adopted, including indexing, the test thereof is to have

it done in such a manner that a stranger to these papers can trace information readily.

It seems immaterial whether the final filing shall be in binding form or loosely in envelopes, so long as each paper in the set is kept intact and readily available. The indexing scheme followed usually ties into the Trial Balance, upon which the key numbers (or letters) are placed, except papers that have no direct connection with a Trial Balance item; these latter ordinarily are filed in a separate folder.

CHAPTER III

COMMENCING THE AUDIT ENGAGEMENT

Scope of Engagement. — The legal responsibility of the client having been established satisfactorily, so that the auditor knows to whom he is to look for his fee, it seems necessary for him next to consider exactly what he proposes to do as against what the client expects to have done. The specific nature and scope of the work should be understood by all parties — client, accounting firm, and senior in charge — since a failure hereunder may cause considerable trouble. The elimination of a possible misunderstanding prior to beginning an audit is emphasized because it seems that many small accounting firms are so pleased in securing a new client and so afraid of losing one that they never go into the matter of what shall be done as against what should be done; the result is that the office frequently is more or less in a continual state of turmoil.

Since the choice between a Balance Sheet and a detailed audit rests primarily upon the adequacy of the system of internal check in use in a particular establishment, the scope of the work to be done ought not to be decided upon until after opportunity has been secured by the auditor to satisfy himself in regard to the internal check system — its form and its actual operation.

Check Marks and Their Use. — Certain check marks are used to indicate postings, additions, and vouchers scrutinized; these are of two kinds:

1. The special rubber stamp consisting of a monogram or of a peculiar device
2. The pen mark composed of an initial made in a unique way or a small check mark characterized by a peculiar twist

Opinions differ as to the use of the special rubber stamp, some auditors maintaining that it is unsatisfactory evidence of personal work. Nevertheless, it seems that the following differentiation is illustrative of general practice:

1. The special rubber stamp is used only to mark vouchers so that they cannot be foisted upon the auditor a second time.
2. The pen mark, consisting of a single initial or of an individual mark, is used in checking postings and additions. Rubber stamping postings and footings, if for no other reason, results in a smudgy appearance being given to a set of books regardless of their neatness. A pen mark should be one readily recognized as that of the auditor and of no one else; this is difficult to imitate and it fixes responsibility on the person using it. Such marks always should be uniform in appearance; to accomplish this, the auditor should carry his own red ink fountain pen and never use a pen picked up at random in the client's office.

The usual kinds of check marks are about as follows:

1. For footings — initials of checker
2. For postings — an ordinary "tick" mark with a short tail (√)
3. For vouching (if rubber stamp not used) — a small letter c with an extended tail (c⁄)

However, the practices followed in a particular office govern closely the check marks employed by its staff. The same kind of a " tick " is not used by every firm for similar transactions. Red or green ink or pencil is utilized generally for all checking, unless specific instructions are issued to the contrary. For example, in making an audit of one year, red ink may be used for checking purposes; in making the same audit a year later, green or purple ink may be employed. By adopting alternate colors for alternate periods, possible confusion, due to considering an old mark as a fresh one, is avoided.

Marks should be placed before the figures checked, as a general rule, except where the same amounts have been marked in doing some other portion of the work; then they should be placed after the amounts. When checking items which are in the same column, the checks should be placed on the same vertical line so that it is determined easily which items remain unchecked after that particular job is completed. Check marks should be neat and inconspicuous; nothing is so apt to arouse a bookkeeper's ire as to show him the pages of his neatly kept set of books covered by a staggered and sprawling collection of check marks.

Preliminary Work. — Assuming that the auditor has completed his preliminary investigation satisfactorily, he is ready to commence the actual work of the audit, that which is considered to be, in general, of a preliminary character and which on most assignments is similar. This refers specifically to the counting of cash, notes receivable, and securities, these counts being made simultaneously (where the auditor has sufficient assistance) or consecutively. Just how much shall be done in connection with these assets directly after they have been counted and listed seems to depend primarily upon the particular auditor's ideas rather than upon any general rule. Some may pass immediately to a consideration of other matters for the time being returning to these assets later; others may do considerable therewith prior to attacking some other angle of the assignment.

The comment in the last paragraph suggests some words of general caution applicable to all audits. As far as is practicable, each section of the work taken up should be completed and definitely cleared to a certain point. The habit of leaving loose ends is all too common; it is a dangerous practice opening opportunities for eventually overlooking or forgetting points of vital consequence, or for inviting the making of fraudulent alterations. Many cases have been encountered where Ledger balances were checked one day and footed the next in which, during the interim between the two operations, the checked figures were altered; had the accounts been footed immediately after checking, these alterations could not have been of any effect. Again, under no circumstances should pencil figures be accepted, unless the auditor elects to ink them in himself (a questionable practice since it opens a possibility of the auditor being accused as a party to a fraud). It seems far better to raise vigorous objection to pencil entries and footings, and insist that all such be inked in prior to commencing work on the books proper; Ledger account balances should be noted at the side of the sheet, or in the explanation space, preferably in ink of a color different from that used in the body of the Ledger.

In view of the possible variations encountered as to just how much work is to be done on each point before proceeding to another (whether partially completing it and returning later, or completing it fully at once), it seems advisable, after commenting

upon the counting procedures related to cash, notes receivable, and securities, to proceed with the idea of presenting in one place the complete coverage of each point as contemplated in these notes.

Cash Count; Cash Schedule. — The auditor in charge, or a junior assistant, verifies by actual count the amount of cash on hand in the various funds. If possible, the auditor should attend at the close of business on the last day of the period under audit (the date of the Balance Sheet), or on the morning following, and count all cash balances on hand, comparing these with the balances shown by the books; only infrequently, however, can this be done inasmuch as the usual audit is commenced subsequent to the close of the term to be reviewed. Perhaps the auditor may find it convenient to attend as above suggested, and then return later to complete the remaining portion of the work.

Where all receipts are deposited in bank, and all payments made by check, some auditors are inclined to believe that no special hurry is necessary to count the cash on hand, although general opinion apparently favors this being done as close to the end of the audit period as can be arranged. Those leaning toward the general rule, count the cash as soon as is expeditious after they arrive upon a new assignment, if this has not been done on the last day of the period under review or on the morning following.

Frequently, where a proper system of internal check is in operation, the cash on hand consists of a petty cash fund operated on the imprest basis, and cash undeposited which was received within the last day or so subsequent to the last deposit. Hereunder it may be sufficient to verify at first only the petty cash and afterward reconcile the bank account. The person in charge of each cash fund should be requested to handle such during the count procedure, actually doing the counting thereof under the eye of the auditor; this is because:

1. The individual in charge of the cash is, as a rule, skilled in handling currency.
2. By not handling the cash himself, the auditor avoids the possibility of becoming involved in any irregularities.

The supervision by the auditor during the count should be exceedingly watchful. In every case, the better practice seems

to be to handle no cash except in the presence of some representative of the undertaking, whose name the auditor includes in the heading of his work sheet.

Where notice has been given to the client's employees that an audit is to be made, and the cash is counted at the beginning of the examination, the auditor should not be satisfied with but one count if later he uncovers suspicious circumstances; he ought to count the cash again at a subsequent time. Where cash funds are in the hands of several individuals, the balances should be verified concurrently or in succession so as to prevent the same cash being produced twice as representing balance in the hands of several persons. It may be necessary in this connection to station one or more members of the auditor's staff at strategic points within the office to keep all such persons under constant supervision during the cash count to prevent transfers being made.

If the cash is counted on a date subsequent to that marking the end of the period under audit, the examiner first may audit each Cash Book up to the date when the examination is made and verify the cash as at that moment, making comparison thereof with book balance; again, he may make the count first and audit the book later:

1. This determines whether the balance agrees with that shown in the Cash Book thereover.
2. This aids in establishing the correctness of the balance at the close of the audited period.

The actual cash counted should be classified by denominations — as paper money, gold, silver, nickels, pennies; the items for each class should be listed in detail and the total of each secured. A working sheet should be headed up for this purpose with name and address or number of the concern whose cash is counted, name of cash custodian, and statement that count was made in his presence; somewhere at the top of the sheet should be entered the exact date, hour, and minute at which the count is begun. When completed, the sheet should be signed or initialed by the auditor under whose guidance the count was made.

All checks encountered should be listed and instructions given that they be cashed at once. If any items represent advances,

proper authorizations to cover should be found and, in turn, these should be referred to the authority indicated for inspection. Every advance to an employee should be investigated most carefully; if any are secured by personal checks, these should be certified by the bank upon which they are drawn before the close of the audit, provided they are not cashed as suggested above. A fictitious check easily might cover a shortage in the drawer. All vouchers found in the drawer should be entered on the work sheet with full particulars, and then be marked inconspicuously to show that they have been seen.

Due bills are not cash; if any were on hand on the ending date of the audit period, or if payments were made for expenditures out of petty cash which had not been charged to the proper expense accounts as of audit date, proper adjustments must be made therefor. When the auditor's report is completed, it should contain the amounts thereof plus the names of the parties for whom carried. If these are officers or employees, comment seems necessary as to whether these due bills are covered by salaries earned not yet due, or whether they represent advances against salaries not yet earned. When due bills are found in the cash, the auditor in his report should point out that such a practice is nothing short of vicious and condemn it accordingly. Whoever the persons may be indulging therein, this seems to be true; if the head of the office be guilty thereof, the condemnation should be more severe than otherwise because, where one in authority commits irregularities, the whole office is apt to reach a condition of demoralization.

In other words, all unusual items in the cash should be listed carefully for investigation. But in this connection, the auditor should not adopt an attitude toward such matters which may react adversely against him. If an employee owes a few cents because he could not make change, the matter is not of itself sufficiently important to take up with the head of the department or with the company president. Anyone competent to be on a case as an in-charge auditor should be able to use proper discretion in such matters. Frequently, bad coins are found, these having been taken in unknowingly; naturally, they must be considered, but the circumstance would not necessarily justify criticism or fault-finding. As suggested previously, an auditor should not adopt the attitude of a detective.

Sometimes small unadjusted items are carried in the cash until their disposition can be determined. Since the cash record should be perfectly clean at all times, these are chargeable to a temporary suspense account; they should be kept out of the cash.

Where all cash receipts are not deposited, the cash count involves nothing more than that covered by any cash count. Usually, however, under such a condition a larger number of items is carried in cash that are not actually so than under circumstances where all cash receipts are deposited intact; this, plus the fact that the safeguarding of the cash is more or less inefficient, means that hereunder the greatest of care should be exercised in inspecting all cash items.

A plan assumed as excellent for saving the auditor the possible ill will of the office is to arrange to have all cash balances at the close of each financial period paid into the bank on the last day of each such period, checks being drawn the following morning for the purpose of reopening the cash accounts. Hereunder, all cash balances are accounted for through the bank's records.

Where checks are found in the cash, it should be determined whether they are current or old:

1. If current, the parties from whom received should have been given credit in the Cash Book for the proper amounts. If this be not so, the checks must be doing duty for entries which are not connected therewith; this means that there is a corresponding shortage in the cash.
2. If old, the following may be the reasons:
   a. They may have been thrown out of bank, marked "not sufficient funds."
   b. They may have been cashed for an officer, employee, or friend and are held as an accommodation.

   Sufficient comment has been made above covering this situation.

Unless absolutely necessary, the amount of cash on hand should not be greater than is needed to meet the demands of the business. If the balances show a tendency to increase, careful inquiry should be made as to the necessity for them and their actual existence. It may be desirable to call the attention of the management hereto in the report.

A form of working sheet for the cash count may appear somewhat as follows:

CLIENT NO. 391 (G.E.B.)

CASH COUNT — JANUARY 6, 1924 — 3 P.M. Made in presence of John Smith, Cashier.

BILLS:		
$20	$¢	
10	$¢	
5	$¢	
2	$¢	
1	$¢	$¢
GOLD:		
$20	$¢	
10	$¢	
5	$¢	$¢
SILVER & OTHER:		
$1.00	$¢	
.50	$¢	
.25	$¢	
.10	$¢	
.05	$¢	
.01	$¢	$¢
I.O.U's:		
December 14, 1923 — H. C. Stevens	$¢	
January 2, 1924 — R. B. Amoy	$¢	$¢
CHECKS:		
January 2, 1924 — C. D. Gilman #1861	$¢	
January 4, 1924 — L. I. Roy #1902	$¢	$¢
VOUCHERS:		
January 5, 1924 — Conroy & Co.	$¢	
January 6, 1924 — A. B. Jones	$¢	$¢
Total		$¢

Balance, per Cash Book, page 819 — January 6, 1924	$¢
Add: Disbursements January 1–6, 1924	$¢
	$¢
Deduct: Receipts January 1–6, 1924	$¢
Balance, per Cash Book, page 803 — December 31, 1923 (See Trial Balance)	$¢

Comment: The quantity on hand of each denomination of currency should be shown against each denomination amount at the left; the quantity count may be made in units of 25 each.

After the cash count sheet has been prepared and totaled, such total should be compared with the Cash Book balance. The auditor may ink in the debit and credit footings in the Cash Book, or have this done for him, after which he may proceed about as under:

1. Draw a line above and below the respective footings
2. Place initials and date alongside of each footing
3. In the Explanation column on the debit side, write in the cash balance in red ink

If, for some reason, a discrepancy occurs between the Cash Book and the cash count, an opportunity should be given the cashier to rectify it.

Regardless of whether a portion of the cash encountered in a particular fund belongs thereto or not, it should be counted; if not a part thereof, a separate record may be made of it. Again, the auditor should make certain all cash funds have been found. Further, speed in the making of the count is essential; one should complete this portion of the work as quickly as possible. Where more than one person handles cash funds, and these are near each other, the auditor should be certain each is watched closely, yet not openly.

After the cash count balance has been compared with the balance in the Cash Book, and the count has been made on a day subsequent to the last day of the period audited, the cash should be worked back so as to determine the balance on the date the audited period closed. (See bottom of cash count schedule, *ante.*)

Trivial Errors. — Reporting every error, however small, which an auditor may discover not only indicates narrow mindedness but may be the means of antagonizing the client's staff without serving a useful purpose. The importance of discovered errors is a relative matter and, naturally, only experience teaches one to distinguish between those to which attention should be drawn in the report and those which need not be mentioned.

Discrepancies of any size in a Trial Balance should not be overlooked, but small errors in petty cash, for example, need not be reported unless frequent, in which event they show habitual carelessness. Dishonesty or gross carelessness is not indicated by the

cash being short a trivial amount; a dishonest cashier is more careful than anyone else to prevent the occurrence of such an error.

Notes Count; Notes Receivable Schedule. — Regardless of the size of an enterprise, the auditor and an assistant, or two assistants if possible, ought to inspect all notes and bills receivable which are presumed to make up the total appearing in the accounts carried therefor; this should be done immediately the cash count is completed, if the examining staff is not of sufficient size to do so simultaneously therewith. Such count should be made in the presence of some substantial representative of the audited concern.

A list of the notes as of the last day of the period under audit should be secured, or the auditor should have a list of his own prepared as of the day of the count. Then all notes on hand upon the day when the count is made, together with the list, should be examined. In general, one person scrutinizes the notes and calls back the data relative to each one to a second person, who enters this upon the above listing; this causes the latter to be extended into the form of a schedule or working sheet, the various items of information shown being some or all of those found in the form illustrated below. The total of all notes must be agreed with the Trial Balance of the General Ledger as of the close of the period under audit.

As the examination of each note is completed, some mark of identification may be made neatly thereon:

1. To avoid having the same note presented a second time, and
2. To protect the auditor should occasion arise under which he is required to specify exactly what he has seen and counted

If the auditor's work sheet covering the count of the notes is sufficiently complete, this marking may be dispensed with, it is believed, so as to avoid the risk of defacing each such document.

All collateral held on account of notes should be seen; infrequently, the value of a note may be no more than the value of its collateral. All notes should be seen physically if possible; complete explanation should be secured as to why some are not available, should this prove to be the case. Further, certification by the holders of notes outstanding is essential. Again, where the

amount shown on the face of a note does not agree with that appearing in the list submitted, the auditor should determine whether or not the difference represents a collection on account; this difference should be indorsed upon the back of the note. It should be determined, also, who has authority to endorse payments on the back of notes, and a memo hereon should be included in the working papers; the cashier should not be the person authorized to make such indorsements.

The remaining points covered in auditing notes and bills receivable are reserved for later presentation.

For specific illustration, the following captions for a working sheet related to a notes count are given below, these being taken from a working sheet most comprehensively columned:

1. Heading of sheet (usual information)
   - *a.* Client's serial number (or name and address)
   - *b.* Schedule title
   - *c.* Schedule date (date prepared)
   - *d.* Name of person in whose presence count made
   - *e.* Initials (or name) of auditor
2. Body of sheet (column headings from left to right)
   - *a.* Date of notes
   - *b.* Maker
   - *c.* Indorsed
   - *d.* Maturity date
   - *e.* Interest rate
   - *f.* How obtained (customer, etc.)
   - *g.* Type (original, etc.)
   - *h.* Amount
   - *i.* Accrued interest (as of end of period audited)
   - *j.* Comment
3. Foot of sheet (reconciliation)
   - *a.* Reconciliation with Trial Balance as of end of audit period

Balance to be accounted for as per above schedule on date schedule prepared	$¢
Add: Notes collected and credited by bank per cash reconciliation	$¢
Balance as per Trial Balance as of end of audit period	$¢

Securities Count; Securities Schedules. — For reasons advanced previously, securities should be counted simultaneously with, or immediately after, the count of cash and notes. Also, such count should be made in the presence of a representative of the audited enterprise; the latter should be required to remain until the physical verification is completed and the securities released from the auditor's possession.

In the original instance, the auditor should distinguish carefully between securities that are permanent investments and those which are current in character:

1. Permanent investments are those representing an interest in an enterprise controlled by or affiliated with the concern under audit. Inasmuch as these represent a control of some essential part of the activities carried on, they cannot be disposed of until a change of policy or purpose is made. In the Balance Sheet, they are set out under the fixed assets heading, or separately.
2. Current investments represent no such interest as is indicated above, since they have no relation to the business beyond that of an income producer. They may be disposed of without interfering with the business activities. In the Balance Sheet, they may be set out as current assets.

Except as to Balance Sheet valuation, to be considered later, it may be said that both classes of securities are verified practically in the same manner:

1. As to inspection of those on hand, and certification of those out in the hands of others
2. As to safeguards to be recognized

Securities comprise stocks and bonds, and perhaps bonds and mortgages. Each kind may be considered separately, particularly as to the working sheets or schedules required, and as to the following matters:

1. Stocks
   a. These should stand in the name of the organization whose accounts are examined. If this is not the case, the certificates should be indorsed in blank.

   b. The documents should be scrutinized closely in order to catch installment payments. If this should be forgotten, and installments exist, it is impossible to balance against the Securities Ledger, or the control.
2. Bonds
   a. Each bond should be examined closely.
   b. In case of registered bonds, the last interest payment should be indorsed thereon.
   b1. In case of coupon bonds, the coupons should be examined to see that the next one coming due, and succeeding ones, are attached and intact. Should any of these be detached, the reason therefor must be secured. If detached for collection, one should not forget to trace and check out. If any bonds are out for purpose of registry, note should be made thereof, so that a later examination will not be forgotten.
   c. If bonds are held by a trustee, it may be necessary to secure from him a certificate confirming the amounts he is supposed to be holding.
   d. Eventually, it is desirable to verify figures at which bonds are carried by reference to the daily papers and financial journals (as *Commercial and Financial Chronicle*).
3. Bonds and mortgages
   a. Each mortgage (which represents bond security) should be scrutinized as to how made, by whom made, in whose favor; if not in favor of the audited concern, a proper assignment is necessary. Further, it should be ascertained that each is properly signed, witnessed, and recorded.
   b. In the matter of recording, certain mortgages may be out for such purpose. If so, it may be necessary to secure a certificate from the County Clerk to the effect that certain mortgages are held for record.
   c. Insurance policies covering properties related to the mortgages should be inspected to determine whether or not the properties are protected amply.

Securities either should be examined by the auditor or should be verified by correspondence with the holders. Prior to beginning the actual examination the auditor, if possible, should be given a complete list of them; if this is impossible to secure, one

should be prepared as the count and verification progress. Regardless of how the list comes into existence, it should be dated and be signed by the person making the examination. Where two juniors work together counting securities, as seems highly desirable, notation should be made upon the working sheet as to just what each one did — who examined and who checked the listed items.

As the count progresses, one junior, say, examining and calling out the particulars of each item, and the other passing upon the accuracy of the list description, the working sheet for each class of securities encountered gradually takes form. For specific illustration, the following schedule captions are offered below as to:

1. Analysis of stock securities
2. Analysis of bond securities

These have been taken from representative working papers prepared by the writer's office. The working sheet relative to bonds and mortgages (covering the bonds) should provide at least for date, name of maker, amount, maturity date, interest rate, date on which interest is payable (if specified), etc., as desired.

The utmost care should be observed in the securities count. Errors seem all too frequent in setting down the descriptions of securities. Undoubtedly, this is due in part to the attitude of assistants in believing they must rush through the work. So many pitfalls are apt to be encountered in verifying this asset that it would seem better to think entirely of accuracy and forget speed. Particularly does this seem to be true where large quantities of securities are to be counted; never should an auditor assume that just because the first few in a package are in order all the rest therein may be passed over hurriedly and the indicated amount on the package accepted at face value.

Further comment upon this asset is offered in a later chapter.

A. Analysis of stock securities
- 1. Heading of sheet (as before)
- 2. Body of sheet (column headings from left to right)
  - *a.* Purchase date
  - *b.* Number of shares
  - *c.* Share par
  - *d.* Block par

  - *e.* Bought at
  - *f.* Cost
  - *g.* Description
    - Issuing company
    - Kind of shares
  - *h.* Valuation of (nearest date at end of audit period)
    - Date
    - Price
    - Amount
  - *i.* Dividends received in (audit period)
  - *j.* Fully paid and non-assessable
  - *k.* Comment

B. Analysis of bond securities
- 1. Heading of sheet (usual)
  - *a.* Client's serial number (or name and address)
  - *b.* Schedule title
  - *c.* Schedule date (date prepared)
  - *d.* Name of person in whose presence count made
  - *e.* Place where examination made (if other than in office)
  - *f.* Initials of auditor (or of assistants and each one's particular duty)
- 2. Body of sheet (column headings from left to right)
  - *a.* Purchase date
  - *b.* Number of bonds (quantity)
  - *c.* Bond par
  - *d.* Bought at (base price)
  - *e.* Total
  - *f.* Interest purchased
    - Previous period
      - Time
      - Amount
    - Present period
      - Time
      - Amount
  - *g.* Total purchase price
  - *h.* Description
    - Issuing company
    - Kind of bonds

i. Valuation on (nearest date to end of audit period)
   Date
   Price
   Amount
j. Maturity
k. Interest rate
l. Interest payments (dates when due)
m. Interest received in (audit period)
n. Accrued interest
   Previous period
     Time
     Amount
   Present period
     Time
     Amount
o. Comment (references to financial papers, etc.)
   Schedule of Amortization or Accumulation, if necessary, in case of long-term bonds.

Bank Confirmation. — Immediately the above-assumed preliminaries have been completed, it seems next in order to have the bank Pass Book sent out to be balanced. Even if this has been balanced in the near past, it may be desirable to have it done again at this time; the auditor should not hesitate to do so if the step appears in order.

Further, certificates must be obtained from the client's banks by letter O.K.'d or written by the client and introducing the auditor, as to the amount of cash on deposit after banking hours on the evening of the desired date, in order to verify the balance; these certificates are secured personally by the auditor, or mailed to him at his home office in one of his stamped return envelopes which should be inclosed with each certificate form. At the same time, to avoid either repeated visits to the banks or unnecessary correspondence, the auditor should make inquiry in his request concerning:

1. Cash balances in bank other than the one mentioned in the letter
2. Liens existing against bank funds
3. Notes receivable discounted
4. Withdrawal on demand

The balances as shown by the certificates must be reconciled with those shown on the Cash Books, the Check Book stubs, or on the Bank Registers, consideration being given to adjustments mentioned above. The delivery of the certificates to the auditor at his home office, or to himself in person, although being the usual procedure, is not considered by some auditors as imperative when the last bank statement shows no signs of having been altered or manipulated in any way.

A form of bank certificate for the present purpose is about as follows:

JOHN JONES
CERTIFIED PUBLIC ACCOUNTANT

Syracuse, New York,
........19.......

....
....

Gentlemen:

We are engaged upon the audit of the accounts of......................
....
and it appears that at the close of business on..................19......
there was on deposit with you to his — their credit the sum of $..........
Be good enough to advise us direct whether the aforesaid balance is correct.

Further, your coöperation will be appreciated in advising us concerning:

1. Any other balances on deposit with you not mentioned.............
   ....
2. Liens existing against deposits held as of above date ....
   ....
   ....
3. Notes receivable on discount with you as of such date.............
   ....
   ....
   ....

Very truly yours,
....

Please furnish the above information as directed:
....
No................

The deposits shown by the books near the end of the period which have not been credited by the bank until the following period should be compared with the bank statement of that sub-

sequent month which should be sent directly to the auditor by the bank, or they should be confirmed by a letter from the depository.

General Ledger Trial Balance: Work Sheets. — The next step, undoubtedly, either following, or concurrent with, the physical verification of the assets mentioned above (depending perhaps upon the experience of the juniors on the case) would be to draw off a Trial Balance of the General Ledger, or to scrutinize one that has been submitted by the bookkeeper. Even though the auditor does accept a Trial Balance prepared by the bookkeeper (which he should have the courtesy to do where offered), nothing prevents him from going ahead and preparing his own. Beyond doubt, the efficient senior reserves the work in connection with the Trial Balance for himself alone, inasmuch as a comprehension thereof opens the entire case to him, at least in a general way; the time spent familiarizing himself with the business and its transactions cannot be wasted if efficiently applied.

The Trial Balance is drawn off on to analysis paper, the exact forms to be followed being illustrated in part in the next section below. In the preparation of these basic work sheets (and control sheets) it seems that the conditions represented by the following questions, at least, should be recognized:

1. Is the audit a new one, or does it represent a repeat assignment?
2. Have the books been closed or are they still open?

These basic work sheets should be arranged and labeled carefully, so that information may be secured therefrom quickly, not only currently but at a later time.

In taking the Trial Balance, the auditor should prove each account balance before entering it upon the working sheet, and he should scrutinize the components thereof closely so as to determine the plan of rearrangement to be followed. Regardless of the form a Trial Balance may assume, the auditor's privilege permits him to rearrange and revamp at will — provided his results are properly keyed back to the original.

The auditor should turn each page in the Ledger from front cover to rear, so as not to miss an account; he should observe everything, even the inside of the front and rear covers since an

account may be carried thereon. Care is necessary so that subsidiary accounts may be recognized where these are included in the same book with their control — as frequently happens. Customers' accounts, creditors' accounts, and memo accounts may be found therein even when they have no place in the General Ledger chart. One should not forget that the Cash account is to be included in the Trial Balance.

The Trial Balance, as prepared, shows the figures as compiled by the bookkeeper. All errors discovered as the work progresses affect these figures, and require adjustments thereof. Such adjustments should be indicated in debit and credit form as uncovered, and each be assigned a number or letter. This permits of their being traced readily after inclusion upon the working sheet and after they have been given the same numbers or letters thereon as assigned in the prepared schedule of entries.

Content of Basic Working Sheets. — The use of such a working sheet is valuable, because:

1. It can be made to furnish both a control and an index over the entire work.
2. It ties up the adjusted figures, as made necessary by the Ledger account analyses, etc., with the book figures and permits the ready tracing of all items from the books to their final adjusted form.
3. It presents conveniently all the elements that enter into the construction of the audited major accounting statements.

In the case of a first audit, where the books have not been closed, the following two illustrative arrangements of the columns upon the working sheet are offered:

1. First arrangement
   a. Ledger folios
   b. Account names
   c. Trial balance at close of period audited
      i. Debit
      ii. Credit
   d. Notations
   e. Adjustment entries
      i. Index (to permit of tie-up between detail debits and credits)

- ii. Debits
- iii. Credits

f. Profit and loss
- i. Debits
- ii. Credits

g. Adjusted Ledger balances (Balance Sheet)
- i. Debits
- ii. Credits

h. Schedule index (to permit of tie-up with Ledger account analyses)

2. Second arrangement

a. First sheet
- i. Ledger folios
- ii. Account names
- iii. Trial balance debits at close of audited period
- iv. Adjustment entries
  - *a* – Index
  - *b* – Debits
  - *c* – Credits
- v. Profit and Loss Debits
- vi. Adjusted Ledger balances (Balance Sheet debits)
- vii. Schedule index

b. Second sheet
- i. Ledger folios
- ii. Account names
- iii. Trial Balance credits at close of audited period
- iv. Adjustment entries
  - *a* – Index
  - *b* – Debits
  - *c* – Credits
- v. Profit and Loss credits
- vi. Adjusted Ledger balances (Balance Sheet credits)
- vii. Schedule index

In the above type of working sheet, it would be an infrequent practice to find the accounts receivable and payable set out in detail. These appear in schedules supporting the totals shown only upon the working sheet. These schedules are proved independently.

In the event of a repeat engagement, where the books have not been closed, the closing or final Trial Balance figures for the previous period audited may be included upon either of the forms illustrated above, preferably in columns to the left of those shown. In fact, regardless of the form of working sheet used, this inclusion seems highly desirable inasmuch as such an arrangement permits the auditor easily to discover or trace changes in account classifications that might have been made subsequent to the last fiscal closing, as:

1. New assets and liabilities
2. The disappearance of items found in an earlier Trial Balance, but not in the later
3. Abnormal changes in the amounts of specific items so that the attention may be focused to making the investigation along profitable lines
4. The necessary adjustment of the nominal elements is facilitated in that considerable safety is secured against oversight of important fluctuations by the facts thus presented

Where an audit is made at recurring times, the Trial Balance as of the close of the preceding period will not be included upon the working sheet by many auditors since the facts thereof are presumed to be sufficiently available in the working papers of the former examination.

In case the client's books have been closed, and a first audit is contemplated, the statements prepared by the client's office will be presented to the auditor when he takes up the work of the audit. Hereunder, some auditors maintain that it is desirable to prepare as a basis of control (or in addition to the regular Trial Balance form of work sheet already mentioned) what may be called a Working Balance Sheet and a Working Profit and Loss Statement — one sheet or set for each.

Again, where the books have been closed, and a recurring audit is in order (or where the figures of some other auditor for the preceding period are to be taken as correct), it happens frequently that a comparative form of Balance Sheet first is spread upon a working sheet, the next two columns to the right holding item increases and decreases. Then the audit procedure contemplates primarily a verification of these increases and decreases.

In any event, regardless of the type of working sheet used as the basis of control, a rough form of Balance Sheet should be prepared soon after the work of the examination is begun so that the auditor may secure therefrom a group picture or snap-shot of the general situation.

Regardless of the form the control working sheet may assume, the spreading thereon of the consecutively numbered or lettered adjusting entries seems in order. Inasmuch as the auditor usually makes adjustments of two classes, as:

1. Those affecting the books of the client (these are to be entered thereon eventually, and are to be posted to the Ledger)
2. Those not affecting the books, but used to adjust book figures in accord with the manner in which the auditor desires these figures to be shown in his final statements (these are not to be entered upon the books, and are not to be posted)

care should be taken to provide proper notations in the working papers so that this segregation may be made later at the time the audit report is written.

Reading the Minutes. — Undoubtedly, a reading of the Minutes by the auditor is valuable (if a corporate audit) in aiding him to become oriented quickly to his assignment. In a corporation, the Minutes of stockholders, directors (or executive committee), and special committees should be read carefully. In a partnership, the partnership agreement should be called for. Copies of all contracts and agreements in existence should be obtained and examined. In the case of a corporation, a copy, at least, of the Certificate of Incorporation should be seen and read.

Abstracts are prepared from the Minutes of important matters; from the contracts, etc., on file; and from the company charter or firm agreement. The exact name of the concern should be noted, date certificate filed, authorized capital stock, par value and classes, names of incorporators; and whether or not directors must be stockholders. If the charter or copy of the certificate of incorporation is not available, a certificate covering its contents may be secured from the Secretary of State. The powers and the duties of the officers are contained in the by-laws, and many other points of importance may be secured therefrom.

Note should be made of the date of the annual meeting so that the report may be completed in time for presentation thereat.

The stockholders' Minutes should show compensation of officers, election of officers, bond of treasurer, banks of deposit, managerial contracts, property purchase contracts, property valuations when properties have been purchased, perhaps depreciation rates, etc. Inquiry should be specific as to bonding of employees; this may or may not be covered in the Minutes of the directors' meetings.

Regardless of how many contract documents exist, it cannot be a waste of time to prepare substantial abstracts of their contents, provided they have any bearing upon the concern's transactions. It may be desirable even to copy important portions word for word so that the exact meaning is available for future reference and guidance.

CHAPTER IV

AUDITING CASH

Plan of Audit. — Certain general principles underlie all audits, although the method of work adopted on a particular assignment varies with the individual training and experience of the in-charge auditor, and with the specific conditions encountered. It is with this variable application in mind that the following comments are offered.

Opinions differ among practitioners as to the advantages accruing from the use of an audit plan or program; many emphatically taboo the use of any prepared form of audit plan blank, whereas others seem to incline toward the opposite attitude, recognizing, at least, that some type of working schedule has certain merits *provided* its dangers and limitations are not forgotten. Whether the program is prepared by checking off items of procedure printed upon a uniform blank plus adding others thereto covering certain particular matters on a specific assignment which have no general bearing or relation to other cases, or is made up on a plain sheet of paper each time a new audit is encountered, seems to merit but scant consideration, inasmuch as some definite record must be kept of the work performed.

For the sake of uniformity, and to be assured that all the work is done which should be done, it is advisable to prepare some plan, the operative responsible for each portion of the work completed initialing each division upon completion. By adhering to such a program, whether built up on a printed blank or prepared in process, the progress of the work can be determined quickly by the principal, and where work is left undone, or errors are overlooked or made, the person responsible may be known quickly, and rectification made before trouble is encountered. In an accounting office properly organized, it seems beyond question of doubt that the principals should be familiar

perfectly with what has been, and is being, done on each audit, at least so that should occasion demand, before a case is completed, one operative may be substituted for another without undue delay.

In case of a first audit, no plan should be prepared too conclusively in advance, inasmuch as that which is to be done may be decided intelligently only as the case opens out; certain general features may be set down more or less offhand, but completion should be delayed until after a considerable portion of the examination has been finished. Careful note should be included of everything that is done since, among other things, this affords material for preparing the plan to be followed in the future upon the same assignment, and even at times upon similar assignments.

The basic disadvantage advanced against the use of an audit program seems to be that, by adopting a prescribed plan of attack, the operative in charge is apt to push his initiative into the background, and do his work automatically. Undoubtedly, the inexperienced auditor, or the floater so commonly encountered in accounting offices during the peak load season, may fall into the rut of following his predecessor's plan blindly — even though the latter has been revised somewhat — and miss absolutely some matter of vital importance which has arisen in that organization subsequent to the last audit. If this adverse possibility could be eliminated, and the in-charge accountant be made to realize that he must make suggestions as to amending the plan — as his experience shows this to be desirable — it would seem that the advantages of using an audit program outweigh the disadvantages. If the audit is not allowed to degenerate into an automatic checking procedure, and if the program is changed or revised from time to time on a repeat engagement as circumstances demand, the system has so many advantages that for an undertaking of considerable size it seems indispensable in some form or other.

Where an auditing practice assumes large proportions, unless some such method is adopted the principals, of necessity, must lose a considerable amount of control over the work being done and, in a large degree, they will be in the hands of their staff.

As an audit progresses, notes must be made apart from whatever records are prepared of the work completed. These should

not be more voluminous than absolutely is necessary since it is highly desirable to clear up as many points as possible the moment they come up rather than to make notes thereon for later consideration. But certain matters always arise which cannot be passed upon at once; for example, missing vouchers for which duplicates must be obtained. Again, it is necessary to make notations concerning matters which must be remembered from one audit to another that cannot be deduced from the face of the accounts themselves. Further, where a first audit is being made of a concern engaged in a business of a technical nature, in which special conditions are encountered, brief explanations are desirable of peculiar or technical transactions so that reference may be made thereto by those who may be required to go on to the case subsequently.

Mechanics of Auditing. — The three following routine procedures form a considerable portion of each audit engagement:

1. Vouching — checking entries from supporting documents
2. Checking footings
3. Checking postings

Although this work is somewhat mechanical, it is important that it should be done carefully and intelligently.

Just how much an auditor should do hereunder on a given case depends upon his hire-contract, the system of bookkeeping, and the internal checks encountered. In a small concern with practically no internal check, a detailed execution should be made; in these cases, too, instructions often are received to balance the books in which event, probably, it will be necessary to check all footings and postings. In a large enterprise, where an efficient internal check exists, and the books are balanced by the office staff, it is not usual or necessary to check completely. Instead, tests are run, but considerable judgment is necessary to decide what shall, and what shall not, be done; since circumstances alter cases, hard and fast rules cannot be prescribed. In other words, on the one hand, a detailed audit should be made, whereas, on the other, a Balance Sheet audit may be attempted, at least in part.

Even though the majority of audits made by the large firms are said to be Balance Sheet audits, it is believed that the large

portion of the cases handled by the smaller firms and by auditors working alone on their own account with a handful of assistants approach nearer the detailed type than the Balance Sheet kind. Under either condition, it seems that the Balance Sheet audit is a rarity since, as mentioned previously, an unqualified audit certificate should not be granted unless the weak spots in a system have been covered thoroughly; although the Federal Reserve Bulletin may be taken as a guide prescribing the minimum requirements of an audit, it does not set out everything that may have to be done to satisfy the auditor that all is well with the report attached to his unqualified certificate. Although the writer's experience is not believed to have been anything peculiar, only covering what has happened to arise in the day's work of a general practitioner, in looking back through his audit plans for a series of years, during a period of some three and a half years not one audit was made which could be labeled a pure Balance Sheet examination; at times one matter, at others many, developed calling for a method of procedure to be applied to a specific point or points that could not be considered anything else but detailed in nature.

Just as soon as the cash, notes, and securities have been counted, the auditor's control work sheet drawn, and the Minutes and other general documents read and abstracted, undoubtedly what is usually known as the detailed mechanical portion of auditing may be commenced. The exact time of starting this division of the examination depends upon circumstances; if the senior draws the Trial Balance and reads the Minutes, etc., beyond question the mechanical — for the most part the junior's — activities are commenced.

Briefly, vouching is applicable to:

1. Cash Books
2. Petty Cash Book
3. Payroll Record
4. Purchase or Voucher Register
5. Purchase Returns and Allowances Book
6. Sales Register
7. Sales Returns and Allowances Book
8. General Journal

The records in connection with which footings may be checked in whole or in part may be illustrated as under:

1–8. Records mentioned above
9. General Ledger
10. Customers' Ledger
11. Creditors' Ledger

All of these books, as a rule, are not footed; as the examination proceeds, and the work develops, the auditor determines just how much seems necessary. Checking postings contemplates a general consideration of the following records:

1. Those from which entries are posted to the General Ledger
2. Those from which entries are posted to the Customers' Ledger
3. Those from which entries are posted to the Creditors' Ledger

Hereunder, also, a complete checking of postings may not be necessary, except as concerns the General Ledger.

The entire success of an audit depends upon the intelligence and thoroughness with which the vouching is done. Vouching does not seem to comprehend merely the inspection of receipts, say, in connection with the Cash Book; it should include the scrutiny of every transaction of the business plus evidence, either documentary or otherwise, of sufficient validity to satisfy the auditor that each such transaction is in order, has been authorized properly, and is recorded correctly. This type of vouching requires the auditor to go behind the books and trace the entries back to their source. Only by so doing, is it possible to determine the complete meaning under the circumstances of the transactions encountered; if an auditor concerns himself only with the entries as they appear in the books, his deductions mostly will be incomplete with the result that many matters of importance affecting the accounts materially will be passed as correct in error. Book entries reflect only such information as the bookkeeper desires to have displayed; hence, such information may be contrary to fact, purposely or otherwise. Only external evidence can give the auditor a correct idea of the true state of affairs; hence, thorough and efficient vouching represents the very backbone of auditing. In general, clever frauds

cannot be uncovered except by vouching; therefore, the greatest of care and intelligence should be displayed in connection therewith.

As vouchers are checked, each should be so marked by a special tick or a rubber stamp that it cannot be produced later to support another item. Further, the marking placed upon the voucher may be so located that its position denotes exactly what has been done with the evidence in hand; an invoice, for example, may be produced once when the Cash Book is vouched, and a second time when the Purchase Record is checked. In a similar manner, the tick marks used on the books of account should be placed distinctively when the corresponding vouchers have been accepted.

In order to avoid a reëxamination of vouchers, with the resultant loss of time, the auditor should endeavor while he has these documents before him during the vouching process to make whatever notes are necessary on various matters to which the attention must be directed later — as contracts needed, expense apportionments and outstandings, purchase prices of materials to be used later in verifying inventories, etc.

In all probability, the first task hereunder is to vouch the Cash Book. In this connection, the auditor ought to determine at once the function of the cash records encountered, and then act accordingly, rather than give much attention to their form and arrangement. Briefly, the following seems contemplated by "auditing the Cash Book":

1. Verify components of receipts and disbursements
   a. In detail, and
   b. In aggregate
2. Prove balance, by
   a. Actual count, or
   b. Bank confirmation, or
   c. Both
3. Reconcile bank account or accounts

The reader is cautioned again to view the suggestions herein made as illustrative only — those matters concerning which an auditor should be familiar as a practitioner (exclusive of mere accounting principles) — but tempered with the essence of a possible procedure so that some idea may be secured of how an examination might proceed.

Illustrative Audit Plan for Cash. — Illustrative of an audit plan for the asset of cash, the following portion of a general printed program is given below:

	Com't.	Do	Done by		
Cash — Cash Book:					
a. Count cash on hand					
b. Deposit checks in drawer, requesting advice of protest					
c. Scrutinize advances, due bills, I.O.U.'s and secure executive approval					
d. Compare cash count with C.B. balance					
e. Have pass book balanced					
f. Secure certificate of balance from bank					
g. Reconcile cash and check books with bank statement					
h. Work back cash balance as of report date					
i. Vouch checks to C.B., examining signatures and indorsements					
j. Clear last cash papers					
k. List checks unapproved and missing					
l. List unchecked items on C.B.					
m. Scrutinize vouchers for check disbursements					
n. Test-Check additions, Dr. & Cr.					
o. Test-Check postings to G.L.					
p. Test-Check postings to S.L.					
q. Test-Check postings to P.L.–V.R.					
r. Test-Check postings to C.L.					
s. Scrutinize vouchers for petty cash payments					
t. Vouch with payroll					
u. Test-Check with daily charge					
v. Vouch cash sales slips					
w. Scrutinize cash system for improvements					
x.					
y.					
z.					

	Com't.	Do	Done by		
Petty Cash — Petty Cash Book:					
a. Count petty cash					
b. Compare with P.C.B. balance					
c. Test-Check vouchers					
d. Test-Check additions: total columns — cross footings — distributions					
e. Check postings to general records: Jl.–L.					
f.					
g.					

In the preparation of this program, each step to be done is indicated by placing a tick (√) mark in the second column at the right titled "Do." If particular developments uncovered require, extra steps are written in at the bottom of each section in the space provided, after which the check mark (√) is placed in the second column at the right as before.

Where tests are to be run, instead of a detailed checking, the word "Check" at the left margin, but to the right of the word "Test" is crossed out in each instance. Further, a brief comment as to what each test covers may be indicated in the first column at the right, headed "Com't." For example, if the audit covers a year, it may be that only the last two months of the period are to be covered by item "*n*" under "Cash—Cash Book"; if so, in the "Com't" column a notation is made, say, "N–D"; naturally, the internal check system must be sufficiently adequate to permit this.

As each person on the auditor's staff, working upon the case in hand, completes certain duties, he enters his initials in the first of the columns at the right headed "Done by," just opposite the item completed. If two juniors do a certain piece of work, each one is provided a space in which to enter his initials. In the event of error, the senior knows just who is responsible therefor; further, in case a good piece of work is done, the senior knows whom to commend. In addition to having each person place his initials in the space provided, as an item of work is completed, each individual engaged upon an audit should carry

a small pocket note book in which to enter the time spent on each portion of the examination; a copy thereof should be filed with the working papers upon the completion of the audit, being fastened to the plan; such information, also, is necessary in making out the weekly time sheet properly.

Should an audit plan be used for several periods, the spread may be upon a columnar sheet. The items of work to be done may be listed at the left downward, and the closing dates of the respective periods entered across the top from left to right.

Internal Checks Related to Cash. — Since a large portion of frauds arise directly in connection with cash, the internal checks over cash should be scrutinized most carefully before the actual audit of the cash transactions is commenced. In the original instance, it should be determined just what are the duties of the cashier — particularly, does he have charge of any Ledgers, or books of original entry other than his own? In a large concern, the regular duties of a cashier, as such, will keep him fully occupied; in a small establishment, it is not possible usually to have one man spend his entire time in carrying out the duties of cashier only. In cases of the latter type, the opportunities for fraud by the cashier are considerable.

In connection with receipts, the auditor's attention is directed to the following points:

1. Who opens letters containing remittances?
2. Are remittance checks stamped immediately "For Deposit Only"?
3. Are remittance sheets used? If so, how checked and O.K.'d? Are daily totals thereof compared with Cash Book entries, and by whom?
4. What method is used in issuing receipts to customers? The cashier should have no duties in this connection.
5. Are all receipts banked daily intact, and does the person who takes the money to bank for deposit have any other connection with the cash transactions?
6. How are cash sales (if any) recorded and checked?
7. May salesmen collect debts; if so, under what conditions?
8. How often is the Pass Book checked against the Cash Book, a Reconciliation Statement prepared, and does anyone assist the cashier hereunder?
9. Who has custody and treatment of the notes receivable?

In relation to payments, the auditor may direct his attention, with profit, to the following points:

1. Are all payments made by check, excepting those handled through petty cash? Who has authority to sign, and is a countersignature required?
2. Are checks made out to "Bearer" a common occurrence?
3. What procedure exists for checking statements against invoices before checks are drawn in payment, and for comparison with creditors' accounts?
4. Are vouchers numbered properly and filed in order? This should not be work for the cashier.
5. How are extraordinary payments authorized?
6. What type of petty cash system is in operation?
7. What system is in operation for preparing payrolls and payment of wages?

When the auditor has completed his investigation along the lines suggested, he is in a position to draw up his scheme for the audit of cash, paying attention to:

1. Weak points in the system
2. All places where, from experience, loopholes are likely to be found
3. Hire-contract with the client

Although it is not part of an auditor's duty at all times to advise the client, without invitation, as to the manner in which the system could be improved and strengthened, this may be done. If so, as the work progresses it is necessary to keep this matter in mind, particularly as to the following:

1. To insure that all receipts from all sources are accounted for
2. To insure that no fraudulent or improper payments are made, that every payment is authorized properly, that each payment covers an actual business purpose, that the transaction is recorded properly in the books, and that the payee actually has received the amount involved

Verification of Cash — Receipts Deposited Intact. — Certain general conditions are encountered when the auditor makes ready to audit this asset:

1. Under an ideal situation, cash receipts are deposited intact, and all payments are made by check except those from petty cash, the fund for the latter being on the imprest basis.
2. Receipts may be used in part for petty cash payments and for other disbursements. Particularly is this true in the smaller concerns.

Where undertakings are located at considerable distances from banks, the cash procedures may be seriously at fault. Deposits may be made spasmodically when someone happens to be going in the direction of the bank; and during this interval payments may be made from the accumulated cash on hand. However, nothing here should prevent the use of a petty cash or working fund out of which cash payments may be made; for safety's sake such a fund should be established and used.

When ready to verify the cash, the auditor should govern himself as seems best to prevent future possible embarrassment. Items in transit between branches or banks at the time of the audit must be watched for, so that their final receipt and correctness may be verified.

Where a satisfactory system of internal check is operated in connection with cash receipts and disbursements, the cash audit should be a fairly simple matter, inasmuch as the cash may be proved in total. The entire receipts shown by the Receipts Register should agree with the total deposits as shown by the Bank Statement, and the payments of cash as shown by the Check Register should agree with the withdrawals shown on the Bank Statement after the outstanding checks have been taken into consideration.

If the Bank Statements are correct, the footings of the cash records are assumed as needing no verification, because they must be correct if they agree with the total of deposits and payments as shown by the Bank Statements after the necessary adjustments have been made:

1. For deposits entered by the bank
   a. At the commencement of the period audited which were entered on the books prior to the beginning of the period
   b. After the period of audit
2. For checks outstanding at the beginning and at the end of the period.

In verifying cash, a proof of the Cash Book footings may be secured by means of the following statement:

Receipts

Deposits of period (see bank statements)		$¢
Deduct:		
Deposits included above relating to prior period (see Cash Receipts Register)	$¢	
Less:		
Contra entries in Cash Receipts Register to neutralize checks cancelled after entry in Check Register	$¢	$¢
		$¢
Add:		
Deposits not included in bank statements relating to present period but credited by bank subsequent thereto (see Cash Receipts Register)		$¢
Total receipts or deposits (see Cash Receipts Record)		$¢

Payments

Payments of period (see bank statements)		$¢
Deduct:		
Checks included above relating to prior period (see Check Register)	$¢	
Less:		
Cancelled checks on Check Register not issued	$¢	$¢
		$¢
Add:		
Checks not included in bank statements relating to present period being outstanding as at end thereof (see Check Register)		$¢
Total payments (see Check Register)		$¢

Summary

Total receipts (see Cash Receipts Register)	$¢
Deduct: Total payments (see Check Register)	$¢
Balance, cash on hand, per books	$¢

Exchange, Collection, and Interest Items. — Even where all receipts are deposited intact, their total may not agree with the deposits according to the bank's records, because of deductions by the latter for exchange, interest, etc. The correct procedure here would be to induce the bank to present monthly statements covering these items so that settlement therefor may be made from petty cash in order that all deposits will be accepted at face

value. If this procedure cannot be secured, a special column may be provided upon the Cash Book in which to hold these items so that, when its total has been deducted from the gross receipts, the remainder will be in agreement with the bank's statement of deposits. A bank holds Canadian checks for collection only.

Interest on discounted drafts cannot be predetermined unless a definite date of payment is specified in the draft. It is impossible to know when a sight draft will be paid, or one reading that payment shall be made "on arrival of goods," so that the net proceeds delivered to the discounting bank will be known before such time.

Bank Reconciliation Procedure. — A practical procedure illustrating one way under which the Cash Book may be vouched and the bank account or accounts reconciled is offered below. The returned checks on hand may be found arranged in one of two possible ways:

1. In bundles, just as the bank returned them. Undoubtedly, this indicates no reconciliation has been made for a long time.
2. In numerical order as issued

Some banks use Pass Books; others have adopted a monthly statement form on which are shown paid checks and deposits; again, if an account is inactive, a Pass Book may be in order, whereas, if an account is active, the statement may be found. Under the first condition, the bank statements, or the machine lists inclosed in the balanced Pass Books, should be checked out before the returned checks are arranged in numerical order; each statement should be proved, or each Pass Book balance proved, before the order of the returned checks is disturbed.

The returned vouchers should be checked against the statement entries or the machine lists. Each machine list should be footed, and such footing checked against the Pass Book. Each Bank Statement should be footed, both as to debits and credits; the opening balance from the preceding statement should be checked, and the closing balance proved. This procedure is done month by month and, if everything is found in order, the checks are arranged numerically, a memo being prepared of the missing numbers.

Where checks are missing, the check book stubs should be referred to to determine whether they are cancelled or still outstanding; if no check book stub is used — as where checks are put up into pads — the Cash Book takes the place of the check book. Cancelled checks should be preserved in numerical order, some advocating their being pasted back on to the respective stubs.

If all checks are drawn on one bank, and are entered in numerical order, it is possible, as a rule, to reconcile the bank account and vouch the disbursements at the same time. From some source the auditor will have determined who should sign checks and who countersign them. The actual procedure of reconciling and vouching is about as under:

1. Compare check number with Cash Book number
2. Compare check payee with Cash Book payee
3. Compare check amount with Cash Book amount
4. Note that proper signatures are on each check
5. Place a small *c* at the right of the amount in the Net Cash column (or a double tick ")

Scrutinizing check indorsements seems unnecessary, as a general rule (subject to exceptions shown below), since most checks have been passed through the bank, paid, cancelled, and returned long after the expiration of the usual ten-day limit. Errors not reported to the bank prior to this moment seem to exceed a reasonable time, and the account may be considered as correct. (See Morgan *vs.* U. S. Mortgage & Trust Co., 208 N. Y. 218.) Further, the auditor is not familiar with signatures, as is a bank teller.

Checks drawn to "cash" may or may not be indorsed; the auditor should turn each one over and note, if possible, who is supposed to have received the money. Examining indorsements on checks drawn to "cash" is a procedure distinct from that of examining them on checks drawn to the order of someone. Considerable more care seems necessary in the first instance, although even if the check should be irregular, this fact may be difficult to detect. In the case of executors and trustees, the auditor is on special notice to scrutinize indorsements on cash checks.

In checking out a bank account, the work entailed usually is done by two persons sitting opposite each other, with a table between. In examining canceled checks, a standardized procedure should be developed so that speed with accuracy may be secured:

1. Place a bundle of checks at the left hand.
2. Pick up a check and scrutinize signature as the check is being moved around toward the front.
3. Call amount, and observe quickly that the written words agree with the figures.
4. Check the check, observing cancellation, and call payee's name.
5. Turn check over.
6. Perhaps examine indorsement as check is placed face down in front for rebuilding the pile.

On the list of the outstanding checks as of the first of each month, check off those paid during the next month and, by checking against the entries, determine those outstanding at the end of the month. The person checking the entries in the Cash Book should watch closely for all items not charged to Accounts Payable or to personal accounts; as to these, evidence of the genuineness of the transactions must be secured.

Deposits, per bank book or statement, are compared with entries of receipts in the Cash Book. Care should be used in comparing the dates of receipt and deposit. All questionable items should be taken up with the senior in charge.

Bank Reconciliation Statement. — The cash on hand at the end of the period should represent the cash in bank as shown by the books. This must be reconciled with the reported bank balance since the latter, because of checks outstanding and sundry charges and credits, is most apt not to agree with the amount shown by the client's books.

The simple form of reconciliation statement need not be shown since it may be assumed as being familiar to everyone having occasion to read this book. It might be mentioned, however, that the starting point should be the balance reported by the bank, rather than that shown by the books, inasmuch as the latter amount should be the final figure secured; it is the book figure which, if correct, represents the cash item for statement purposes, rather than that reported by the bank.

Ordinarily, the checks outstanding at the end of the period under review, where the audit is made immediately after the close of the period or is completed directly thereafter, cannot be verified actually unless sufficient time has elapsed to have them cleared through the bank. Special care is necessary to see that no checks for cash purposes are drawn at the close of the period and entered in the next period. Checks outstanding, not examined at a previous audit on account of not having been returned by the banks must be called for and be traced into the Cash Book at the beginning of the current period being reviewed.

Where the cash account is more or less complicated, the reconciliation of a bank account may require a more formal method than the usual simple one suggested above. In this case, the tabulation may be constructed along the following lines — in four parts or tables:

1. We debit, bank does not credit.
2. We credit, bank does not debit.
3. Bank debits, we do not credit.
4. Bank credits, we do not debit.

On the basis of the above, the auditor proceeds as follows:

1. Balance per bank.
2. Add (1) and (3) above.
3. Deduct (2) and (4) above.
4. Balance per Cash Book should result.

Instead of the above arrangement, the statement may be prepared in account form:

1. Bank balance	1. Our balance
2. Add (1) and (3) above.	2. Add (2) and (4).

When completed, the two sides should balance one with the other. This tabular form of statement may be used in balancing many sets of accounts between two parties, when the reciprocal items are so numerous as to make the process complicated, as:

1. Between home office and branch
2. Between stock brokers in two different cities, where these are buying from and selling to each other constantly
3. Etc.

CHAPTER V

AUDITING CASH (*Continued*)

Bank Pass Book. — One portion of the work of vouching the Cash Book is to check it against the bank Pass Book (or Bank Statement). The individual items in the Cash Book are called back against the Pass Book, the entries on both records being ticked; then the Reconciliation Statement at the end of the period, where prepared by the office staff, should be checked, so that the balances of the Cash and Pass Books may be agreed. All checks paid in or drawn, not in the Pass Book as on the ending date of the period, and which appear in the Reconciliation Statement, should be traced into the bank in the succeeding period, so it may be determined that these represent *bona fide* transactions. Where the audit is made sometime after the close of the period, and checks are encountered not yet cleared through the bank, the reasons therefor should be ascertained.

In checking out the debit side of the Cash Book against the Pass Book (or Bank Statement), it should be observed that the dates agree; many frauds are committed by the simple expedient of delaying the banking of receipts, this permitting the defaulting person to have the use of such money in the interim, so that at all times he is in possession of part of the business funds.

When the credit side of the Cash Book is taken up, it should be noticed that dates and names correspond, and bank charges, dishonored checks, etc., should be considered. Where a Reconciliation Statement is handed the auditor, perhaps he will check only the credit side of the Cash Book in total; nevertheless, a more secure procedure hereunder would seem to be to check out the entire debit side in detail, and to note, inquire into, and take account of all contras when agreeing the credit side in total.

Since frauds have been covered by producing a fictitious Pass Book to the auditor, the confirmation certificate secured direct from the bankers should not be forgotten. The balance hereon should agree with the Pass Book balance produced.

Auditing after Close of Period Covered. — After the bank confirmation has been secured, and a copy of the undertaking's bank reconciliation obtained for the month just prior to the period's close (say, November) — or the balanced Pass Books, and the Cash Book (or Cash Registers), the auditor should prepare a Bank Reconciliation Statement as of the date of the actual count; also, the transactions should be traced or worked back to prove the balance sought — the one to which he is expected to certify.

If the book balance is verified under the present circumstances, the balance at the end of the period under audit as shown by the books may be proved as follows:

Balance (present date) per books	$¢
Add — Disbursements from end of period to date above	$¢
	$¢
Deduct — Receipts from end of period to date above	$¢
Balance, as of end of period under audit. (See Trial Balance)	$¢

Taking the canceled checks returned by the bank as of the close of business on the last day of the period under scrutiny, and all those which have been returned subsequent thereto, the auditor checks out the Cash Book for the last month of the period (as December) and every check belonging to the preceding month (as November) found in the bundle for the last month (as December) should be traced into the reconciliation obtained from the concern for the month preceding the last (as November). At the completion of this procedure, all items in the Cash Book and in the reconciliation for the month prior to the last one of the period which remain unchecked should be traced into the reconciliation as of the end of the period being examined; everything should check out. Thereafter, the reconciliation schedules of the auditor may be prepared.

Inasmuch as the checks outstanding at the end of the period, as a rule, will have been returned by the bank subsequent to the close of the period but before the audit is completed, a verification thereof should be made, and this proof of checks outstanding should be thorough. In the words of the Federal Reserve Bulletin, the "only safe and satisfactory method of proving their accuracy is to compare the credit side of the Cash Book

from the last day of the period backward, item by item, with the checks returned from the bank for such period as may be necessary to account for all the current outstandings." Care should be taken to make certain that in each instance the payment date (per bank) was later than the last day of the audited period. Occasionally the auditor will find himself on an assignment just prior to the end of the first month of the new period which follows that just closed; hereunder, if possible, he should arrange to have the bank statement for this particular month given to him unopened, inasmuch as this may provide the means for facilitating the verification of outstanding checks.

Further, the deposits for each day of a week or two prior to the close of the fiscal period should be compared in detail with the Cash Book by checking there against the itemized deposits shown on the duplicate deposit slips — these preferably carrying the bank cashier's stamp. Sometimes, it is necessary to make this comparison against the Pass Book; this latter comparison seems not as desirable, however, as the former method of examination. The purpose of this procedure is to detect what is known as "Lapping."

Again, the deposits for the last month or two weeks of the audited period may be checked out against the bank statements; if any are found on the books but not on the bank statement, it is necessary to cover by Journal entry. In auditing the bank statement of the first month of the next new period, any such unentered deposit must be traced thereto.

As intimated before, where the reconciliation is prepared some time after the close of the period being examined, it should cover all funds as of the day of the count, as well as of the close of the last day of the audited period.

Check Kiting. — This may be detected by checking in detail the deposits of the last few days of the period and comparing them with the receipts in the Cash Book. If a check drawn on one bank by the company was deposited in another bank without being credited to the bank on which it was drawn prior to the close of the period under review, a false balance would be established; such check would be held over and be used against another and later abstraction; this process is said to "kite" the amount over the closing time. The same would be true where

a shortage is made good by an undeposited check held over for reasons similar to those given above.

Further, close scrutiny should be given all cash items entered just before and after closing. Again, the amount of the sales roughly may agree with the amount of the deposits.

Verification of Cash — Receipts Used in Part for Petty Cash Purposes. — Considerable more care must be exercised, and much more work must be performed under this situation than where the cash is controlled by a proper system of internal check.

The present procedure may be suggested as follows:

1. As to receipts
   a. Determine amount of cash receipts deposited
   b. Balance must represent loose cash to be accounted for
2. As to payments
   a. Determine amount of checks drawn
   b. Balance must represent currency payments
3. As to balance (composition)
   a. Cash on deposit
      i. Verify by bank communication and reconciliation
   b. Cash on hand
      i. Verify by actual count

It is noticed from the above that the cash receipts and payments must be classified separately as between bank and currency items. The receipts deposited are checked against the Bank Statements; all receipts not accounted for hereunder should be totaled and such total be used for proving the actual cash on hand in accord with the cash count. Likewise, the disbursements by check should be compared with these statements; all payments not thus accounted for should be totaled. All footings in the Cash Book for the entire period should be verified, canceled checks examined, all authorizations for currency disbursements inspected and, where certain of these currency disbursements do not appear to be authorized, authorization should be secured before this angle of the case is left; the latter means that someone in authority must give the auditor written authorization covering all these petty disbursements before he will accept them.

All disbursements may be vouched when the checks are compared with the entries upon the Cash Book; expense distributions usually are found upon the Cash Book unless a voucher system is in operation.

If the balance is verified as on a date subsequent to that representing the end of the period under audit, it is necessary, as before, to prove back the cash balance as of the ending date of the audited period. The form of Reconciliation Statement used is somewhat similar to that adopted where the receipts are deposited in bank intact. It is illustrated as follows:

	Bank	On Hand	Total
Balance (at date of count)	$¢	$¢	$¢
Add — Payments from end of period to date of count .	$¢	$¢	$¢
	$¢	$¢	$¢
Deduct — Receipts from end of period to date of count .	$¢	$¢	$¢
Balance (at end of period audited)	$¢	$¢	$¢

All footings for the entire period and down to the time when the cash is counted should be verified; the totals should be inked in and then initialed in ink.

It seems desirable, where the cash transactions between the ending date of the period and the date of the count are not too numerous, to verify all such items.

Vouching the Debit Side of the Cash Book. — Apparently, it is more difficult to vouch this side of the Cash Book than the credit side, since the auditor should not be as much concerned with what the Cash Book shows, as with what it should disclose (receipts may be omitted). The result is that he must fall back upon the internal checks and upon evidence more or less indirect.

If duplicate deposit slips have been prepared and stamped by the bank, a proportion of them, at least, should be checked with the Cash Book; this is to determine, particularly, that all moneys received have been paid in bank promptly, and that checks have not been split improperly. The splitting of checks may occur as follows: A payment of $100.00 by A & Co., to settle their account is misappropriated, so that it does not appear either in the Cash Book or in the Customers' Ledger. If nothing further is done, attention must be directed to the account after

a time, as when the next statement of account is sent them, and the fraud discovered. In order to prevent this, a later check from another customer, X & Co., for $200.00 is entered in the Cash Book as A & Co., $100.00, and X & Co., $100.00 on account, and the check paid into the bank. In this manner, the first account is closed and the peculated amount transferred to a new account. In case fraud is suspected, but the means are not available, as above, for unearthing something, it may be possible to make arrangements with the bank to obtain temporary possession of the original deposit slips. In most cases, these cannot be taken away from the banking house, it being necessary to do the requisite work in the bank's storeroom; some depositories, however, may refuse all privileges of this kind unless the audit relates to an income tax investigation by a representative of the Internal Revenue Office, or the auditor is well known to some one of the bank's officers.

Duplicate receipts may be tested against the Cash Book, although it should be remembered that a defaulter will have no trouble making these agree with the Cash Book regardless of what amounts may have been included in the originals. Such tests appear somewhat useless.

Undoubtedly, the best check on cash received from customers is to have those who collect and handle money in no way connected with preparing and sending out the statements of account. Naturally, if a customer receives an incorrect statement, he will draw attention at once to the fact that a sufficient amount of credit has not been given.

In connection with cash sales, the auditor is dependent primarily upon the system thereover. If cash registers are used, some official should keep the keys in his possession; the register records should be tested by the auditor against the cash accounted for under this heading. Where floor salesmen are numerous, none should be allowed on any account to receive cash; for each sale, a bill may be made out, the customer paying a desk cashier who keeps a record on a desk sheet or blotter. Daily summaries are prepared from the salesmen's books; the totals of these are agreed and checked against the desk cashier's summaries, and against the total of cash from such sales which has been paid into bank. Unless some such system is in vogue, or

if that which is used is bad and faulty, the auditor cannot vouch cash sales satisfactorily; he should disclaim all responsibility in this connection in his report until the system employed is revamped into one that is efficient. In accord with the cash sales system in use, the auditor outlines his vouching procedure.

Sundry receipts, at times, are difficult to check inasmuch as the evidence required depends upon the nature of the items encountered. Rents received may be checked against the Rent Register or agents' accounts. Leases and tenants' agreements may be examined to determine what should have been received. The rent book, sometimes carried by the collector, may be secured to ascertain that all rents entered in it have been accounted for. Interest and dividends from investments may be checked against correspondence on file, financial journals, bank Pass Book where bank collects, and bond coupons remaining attached to bond securities; the coupons torn off are presumed to represent interest that should have been received. Interest on deposits may be vouched against Pass Book entries. Commissions received may be vouched against statements submitted. Agents' receipts may be checked against accounts rendered, the latter having been checked and passed by a responsible party other than the cashier. Loan interest may be checked against the loan contract or whatever other evidence of the loan exists to determine that all interest as provided has been accounted for.

Amounts received from notes receivable may be checked against the Note Book, all notes which are due being accounted for. Proceeds from the sale of investments may be checked against the broker's statement showing the net amount to be received. Proceeds from the sale of sundry assets must be checked with whatever evidence is available — as correspondence, contract of sale, auctioneer's statement plus marked catalog, etc.

Vouching the Credit Side of the Cash Book. — In this connection, most of the papers produced consist of invoices, receipts, and receipted statements of account. When these are examined, the auditor should compare the payee's name with the name given in the Cash Book. Again, he should notice account dates, since by doing this he may find that accounts which should

have been charged to Profit and Loss last year are included in the current year's business:

1. Such error may be accidental; if so, proper precautions should be taken not to have future recurrences.
2. It may mean that in the past there has been a fraudulent manipulation with the object of inflating profits.

Dates should be examined to guard against vouchers of former periods doing duty in supporting fraudulent payments in the current period. The composition of goods supplied or services secured should be noted, to determine that they represent proper charges against the business; it may be that the private accounts of individuals are being paid by, and charged to, the enterprise. With this possibility in mind, the name of the party to whom accounts are addressed should be examined. Frequently, private accounts are paid through the business so that the person may secure the concern's discounts; naturally, such amounts should be charged to that person's account on the books.

The amount of each voucher should be compared with the amount in the Cash Book, and discounts should be dealt with properly to assure of their being in order; unauthorized discounts may indicate a misappropriation of funds. Each voucher should be checked and passed in due form prior to payment, and the correct Ledger account should be debited therewith. Where a creditor specifies on his invoice that only a particular kind of receipt will be recognized, none other should be accepted without caution. Invoices receipted merely in ink or in pencil should be scrutinized carefully, since it is a simple matter for the cashier to receipt such fraudulently; printed receipts and invoices stamped with the creditor's rubber stamp seem to represent better evidence of payments made in order than the invoices or statements marked out with pencil or pen.

Where voucher checks are in use, it may be that such are not acceptable as satisfactory evidence, from the auditor's viewpoint — as where particulars are lacking as to the nature of the payment. Further, they may not represent good evidence that the payee has received the amount shown, since the possible danger is present that such forms may have been completed

fraudulently; such fraud is most difficult to uncover. The corresponding invoices or statements of account should be attached, so that the particulars may be seen and verification made that payment was in accord therewith.

Vouching Payments in Settlement of Purchase Ledger Accounts and Payments to be Debited to Impersonal Accounts. — Where payments are made to settle balances in the Creditors' Ledger, it may not be necessary to examine the invoices inasmuch as they will have been scrutinized (perhaps) when the Purchase Record was vouched (if same be done); the vouching of the Purchase Record is commented upon at a later time. This would be true where creditors' receipts are available. But where payments are made which offset charges to impersonal accounts, invoices and statements should be produced so that full particulars of each transaction are at hand; in addition, the auditor may find it necessary to refer to his notes of the Minutes, to contracts, etc., before he can pass such payments. It is doubtful if too much care can be applied to this portion of vouching the Cash Book.

All capital expenditures should be vouched most carefully, to make certain the payments are in order and that the charges have been made properly against capital. The documents necessary in connection with this angle depend upon the nature of the payment. These are considered later when the various other assets are commented upon as to valuation and verification.

Indorsed Checks as Vouchers for Payments Made. — All missing vouchers should be listed, and a request made that these be found; where missing vouchers cannot be located, it seems advisable to insist upon duplicates being obtained. Frequently, the indorsed checks are produced instead, it being presumed that these will be accepted as sufficient evidence. But except in special cases, the auditor may err disastrously if he accepts them as such, because an indorsed check:

1. Is not good evidence that the payee has received the amount; the indorsement may be forged
2. Is no evidence as to the nature of the payment

It would seem that an indorsed check might be deemed a sufficient voucher only when the payee's signature is known to the

auditor, and other evidence exists as to the nature of the payment, that it is in order and correctly authorized. This might occur in the case of salaries, directors' fees, and partners' drawings.

Even in the cases above, it seems advisable to demand proper receipts, where possible. In connection with partners' drawings, the partners should be requested to examine their accounts and, if in order, to O.K. them by writing their initials thereon in the auditor's presence.

Vouching Payments for Wages, Salaries, Commissions, etc. — Where the wages item reaches fair proportions, the question of its audit assumes considerable importance. To begin with, there should be a most complete internal check thereover. An examination should be made of the method of recording and paying, and if this is found to be poor, the auditor should point out its failings and disclaim responsibility; under such circumstances it seems impossible to prevent, or to be certain of uncovering, frauds. Regardless of the exact manner in which the system of recording and paying may operate, the time tickets, the preparation of the payroll, the checking of the payroll, the handling of the cash, and the payment of the wages, should each be under separate and independent control. Those directly interested in the business as principals ought to watch the wages system carefully, and from time to time either take part in or observe the actual paying off. The vouching necessary has been suggested previously in Chapter II, in connection with "Sundry Kinds of Audits."

The auditor should check out the checks drawn for salaries against the salary lists, and each of the latter should be initialed by some responsible official or partner. All alterations and changes should be confirmed in the same manner.

In the case of traveling salesmen's commissions and expenses, the auditor's task may or may not produce a result entirely satisfactory. Vouchers should be insisted upon for all expenses, except railroad fares, etc., for which no receipt can be obtained. It seems more to the advantage of the management to watch and check these expenses than for the auditor to criticize. Checks drawn in payment should be vouched against the expense accounts submitted, and all unpaid commissions and expenses outstanding at the end of the period should not be forgotten.

Petty Cash. — The treatment of petty cash may be set out summarily as under:

1. Where operated upon the imprest basis.
   a. Count and list currency on hand in the fund
   b. Count and list undeposited checks, vouchers, and I.O.U.'s found in the fund balance
      i. As to undeposited checks (checks cashed not deposited)
         a – List name, dates, amounts, banks, etc.
         b – Cash at once to eliminate chance of their being used to cover shortage
   c. Hereunder, also, the check which replenished the cash fund for all expenditures made up to and including the end of the period audited, should be noted as having been received on the books prior to the closing of such period. If this be not the case, a comment should be included upon the petty cash schedule as to the exact day on which such check was received.
2. Where not operated on the imprest basis
   a. Apply the following formula: *Balance* as of the *beginning* of the audit period; *add* all verified charges to the account; *deduct* all vouched disbursements; *equals balance* as of the *end* of the audit period.

Where a Petty Cash Book is used, this should be audited in the same manner as the General Cash Book — as to footings, postings, etc. In general, where advisable, only a portion of the vouchers will be checked out completely. When this is being done, the nature of the payments, and the headings under which they are analyzed should be observed. In this connection, under the imprest method, it would seem highly desirable to have some responsible official approve the petty cash records as checks are drawn for the reimbursement of the fund.

Proving Cash through Other Accounts. — Sometimes it is not only possible but advisable to prove the cash through other accounts. For example, if most of the cash received comes from accounts receivable, the cash receipts may be proved by deducting the final balance of the accounts receivable from the sum of the beginning accounts receivable balance and the charge sales

for the period, after making the adjustments necessary for allowances, discounts, and accounts written off or adjusted, and subsequently adding thereto the cash from cash sales and other miscellaneous sources after proper adjustment. In this particular instance, such a test is valuable, also, in indicating the amount of credits to accounts receivable other than cash; excessive amounts thereof when investigated closely may lead to the discovery of manipulations or actual peculations.

In fact, whenever possible, accounts should be tested out by means of other interdependent or related accounts; such procedure may lead to important and startling disclosures.

Footing the Cash Book. — Some auditors test the Cash Book out by footing, perhaps, only every fifth page. This practice usually is all-sufficient to unearth extensive frauds covered by forcing the Cash Book footings, but an occasional mistake, whether intentional or accidental, is apt to be missed.

When accounts are abstracted, instead of checking out the records of original entry, the abstract itself proves the addition of the General columns.

The only safe plan, in any event, seems to be to verify all Cash Book additions. Even though an auditor should be conscientious in keeping the audit cost down, never should he sacrifice the thoroughness of his work to reduce its cost. It is far better to have the reputation in a community of charging high fees and doing good work than that of charging low fees and doing poor and unsatisfactory work.

Columnar Cash Book. — The footings of all special columns upon a Cash Book always should be verified. Since only the totals of these are posted to the Ledger, a false addition may not affect the Trial Balance and hence may not be detected unless the additions are proved. This verification seems important since a bookkeeper purposely may make a false entry in a special column without including it in the footing in an attempt to discredit the auditor in the eyes of the client should the trap not be detected.

Every payment charged to an Expense column should be scrutinized carefully to make certain the charge does not belong in a personal account. Frequently, one who has authority to sign checks purchases articles for his personal use charging an expense account therefor.

A General Expense account on the credit side of the Cash Book should be discouraged since its use is conducive to fraud. Whenever such a column is encountered, an analysis should be made of it for inclusion in the completed report. Naturally, since the addition of the analysis columns proves the addition of the total of the General column, the footing of the latter in the usual manner may be dispensed with.

Balance Sheet Audit *versus* Detailed Audit — Cash. — In auditing the cash for a Balance Sheet audit, the following illustrative procedure is outlined as being representative:

1. As to petty cash:
   a. Count currency and list.
   b. Examine checks undeposited, scrutinizing dates, amounts, and indorsements; have same deposited in bank, or verify their reliability otherwise.
   c. Scrutinize closely all vouchers, receipts, and memos; this may resolve itself into merely securing approval by someone in authority.
   d. List all items separately and reconcile with fund.
   e. Work back total to audit date.
2. As to reconciliation of bank balances:
   a. Compare canceled checks with record entry; list all discrepancies between check data and record data; check off record amounts compared.
   b. List all unchecked record items by check numbers and amounts.
   c. Compare Pass Book or duplicate deposit slips with record of receipts and with deposits per bank statement; list deposits made in last month of audit but not credited by bank until in the subsequent month.
   d. Reconcile conclusions reached with bank statement.
   e. Verify deposits in transit as at close of period by correspondence or otherwise.

In auditing the cash for purposes of a detailed audit, one might outline a complete procedure about as follows:

1. Balance cash at once.
   a. Petty cash. Count and reconcile.
   b. Other cash. Count and list by making full record of it, plus checks undeposited.

2. Have Pass Book balanced, secure canceled checks and bank confirmation as to balance on deposit.
3. Agree beginning balance with balance per previous Balance Sheet or audit papers.
4. Reconcile Cash Book with bank certificate.
5. Clear checks outstanding as of beginning of the period.
6. Prepare summary of Cash account by months, showing balance on hand at beginning of period, receipts per Cash Book, payments per Cash Book, and ending balance.
7. Prepare summary of Check Book account by months, showing for the same period the balance on hand at beginning of period per Check Book, deposits, checks drawn, and ending balance.
8. Prepare summary of Pass Book account by months, showing for the same period the balance on hand at the beginning of the period per the Pass Book, deposits, canceled checks, and ending balance.
9. Compare canceled checks with Cash Book payments, scrutinizing indorsements and comparing payee with Cash Book entry, stamping canceled checks with a stamp to prevent substitution, and making necessary working sheet memos covering irregularities found. Make list of all checks and bank charges not appearing as entered on the Cash Book, prepare list of all checks outstanding, and schedulize all payment items on the Cash Book not checked during this process of comparison. Note indorsement irregularities. Finally, make a check mark on the Pass Book summary to indicate that the cash has been vouched with the checks.
10. Reconcile total payments on the Cash Book summary with the total checks on the Check Book summary.
11. Reconcile total checks on the Check Book summary with the total canceled checks on the Pass Book summary.
12. Reconcile total payments on the Cash Book summary with the total canceled checks on the Pass Book summary.
13. Reconcile cash receipts on the Cash Book with the deposits.
14. Reconcile total receipts on the Cash Book summary with the total deposits on the Check Book summary.
15. Reconcile total deposits on the Check Book summary with the total deposits on the Pass Book summary.
16. Reconcile total receipts on the Cash Book summary with the total deposits on the Pass Book summary.
17. Vouch disbursements with paid bills or other vouchers,

stamping all invoices attached to vouchers, as well as vouchers, scrutinizing all signatures on approved vouchers, and tracing to the proper capital and revenue accounts. List all missing vouchers.

18. Foot the Cash Book for the entire period. This seems to be advisable under all conditions.
19. Check all postings to the Ledgers.
20. Secure second bank certificate near the close of the audit, check returned checks, and prepare final reconciliation.

Overdrafts on the Balance Sheet. — Where a concern has several depositories, and any one bank account is overdrawn, the net amount on deposit should not be presented in the Balance Sheet. The total cash on deposit should be shown on the asset side of the Balance Sheet, and the overdraft should be included as a liability under the grouping of current liabilities.

Suggestions of Auditor on System — No System of Internal Check. — The auditor should show the client the value of cash control and, in connection therewith, he should stand ready to propose the necessary forms and routine needed to accomplish these ends. However, any such proposal must be made with utmost discretion in order not to antagonize the client or his staff. Again, as mentioned before, where bank balances are found too large to be consistent with the needs of the business in question, the auditor wisely may disparage such practice; even though large bank balances may add color to the Balance Sheet, as a rule they seem to indicate a tottering business policy. Where surplus funds are not to be used to advantage in either expansion of sales or in the enlargement of production, they should be placed in special deposit or in savings accounts, or in ready convertible securities, where they will earn some interest.

In other words, the auditor should be more than a checker of figures; he may render as much efficient service to a client along constructive lines as in doing anything else. In fact, he should take an interest in things other than figure accuracy; thereby he may secure the everlasting respect and goodwill of his client.

Conclusion. — The extent of the cash examination seems to be a relative matter, dependent entirely upon the auditor's discretion and the particular circumstances encountered. The securing of an absolute check always is most desirable but, at times, this may not be justified or even acceptable to the client.

The right kind of an audit should cover thoroughly all weak spots, but what these may be on a given assignment cannot be determined in advance; the proper coverage of the weak points is dependent more upon experience than upon a knowledge of abstract theories. Naturally, where irregularities are suspected, the most thorough check possible should be obtained. Dependent upon the circumstances encountered, and upon the freedom permitted the auditor to satisfy himself thoroughly that everything is in order, rests the phrasing of that portion of his Audit Certificate which relates to this part of the work.

The method employed in auditing the cash should be both simple and complete so that the auditor may be enabled to perform his duties in as short a time as possible even when the work is extensive. In general, what he is desirous of securing through his audit efforts may be summarized as under:

1. To prove the correctness of the Cash Book footings
2. To prove the correctness of the Check Book footings
3. To prove the correctness of the bank account
4. To detect all errors and adjustments affecting cash
5. To detect all contra entries
6. To detect all errors in the Check Book
7. To detect all errors in the Pass Book
8. To detect all items entered in the Cash Book but not deposited
9. To detect all items passed through the bank without entry in the Cash Book
10. To detect all errors of omission and commission
11. To secure absolute control over the cash and bank

CHAPTER VI

AUDIT OF THE ASSET ACCOUNTS
NOTES RECEIVABLE—SECURITIES

Introduction. — In auditing the Balance Sheet, one should remember not only the charge and discharge rule, but the fact that the Balance Sheet as of a particular date is to be revamped; hence, it is necessary to determine what assets actually were on hand on that certain date — non-Ledger as well as Ledger assets, since the former play as important a part in net worth determination as do the latter.

A Balance Sheet and Profit and Loss Statement usually are submitted as prepared by the regular office staff. If possible, similar statements should be secured for several years previous, and at least for the preceding year. Reports by other accountants, reports on appraisals and documents of a like nature, contain considerable information of auditing value.

In the case of a regular client, the staff operative has available in the files of his office working papers, audit program, and miscellaneous documents from previous visits, by means of which an intelligent grasp of matters may be secured even though that particular assignment is new to him. Reports of other accountants, if available, should be studied for the information they contain, not for the purpose of criticism; criticism may be merited, and it may be even necessary to correct the work done by former auditors, yet unfavorable comment should be suppressed.

The Balance Sheet to be audited is proved against the Trial Balance and, in turn, the latter is proved against the Ledger. Similarly, the Balance Sheet and Trial Balance as of the beginning of the period should be proved and agreed with the Ledger. Such procedure establishes a connection between the statements in hand and the Ledger; by so doing, the Ledger accounts may be analyzed with the confidence that the amounts in the statements actually are those being traced and scrutinized.

The opening and closing Trial Balances, drawn from the Ledger, may be displayed in parallel columns upon an analysis sheet, with space to the right for additional work in the way of facts and comments. Abstractions should be proved, and additions within the current period should be proved. Accounts opened and closed during the interim, transfers, etc., should be marked as necessary for further examination. In this manner, certain lines of procedure are suggested to the auditor, which he may note upon the working sheet against the particular items, — as "analyze fully," "trace back to acquisition," etc., just as he desires to have the work carried out.

In conclusion, concerning general instructions for making a Balance Sheet audit, consider the following summary thereon prepared from the content of the Federal Reserve Bulletin:

1. Prepare Trial Balances of the General Ledger, both at the beginning and at the end of the period under review, in comparative form, and check these against the Ledger.
2. Trace the Trial Balance items into the Balance Sheets before verifying the assets and liabilities to prove that:
   a. No contra asset or liability has been omitted from the accounts.
   b. The assets and liabilities have been grouped similarly at the beginning and at the end of the period.
3. Trace and note on the working papers the disposition of any General Ledger assets and liabilities that may have been scrapped, sold, written off, or liquidated during the period under review.
4. Scrutinize the General Ledger to see that the accounts, if any, opened and closed during the year have no bearing upon the company's financial position at the close of the fiscal period.
5. Secure copies of the Balance Sheets at the beginning and at the end of the period to be audited; upon the basis thereof prepare:
   a. Comparative Balance Sheet to obtain a comprehensive view of the changes in the figures during the period under scrutiny.
   b. Statement of Profit Disposition from the Comparative Balance Sheet as a further aid in impressing the meaning of the figures upon the mind.

Illustrative Balance Sheet. — In order to establish the primary scope of the future work as presented in this volume, the items discussed are considered basically in the order in which they appear upon the following illustrative form of Balance Sheet. Those shown seem sufficient to illustrate principles even though in a particular case a more or less detailed arrangement, order, and set-out may be desirable:

Assets

Cash	Accounts Receivable
Notes Receivable	Inventories
Subsidiary Company Stock	Fixed Assets
Investments	Deferred Charges
Sinking Fund	

Liabilities & Proprietorship

Notes Payable	Reserve for Sinking Fund
Accounts Payable	Common Stock
Accrued Liabilities	Preferred Stock
First Mortgage Bonds	Surplus
Reserves	

Scope of Asset Verification. — In general, asset verification contemplates tracing items in and out of the control of the management. In his work, the competent auditor is guided by specific theories, as a general proposition, but he is careful not to err by following them blindly; reason and common sense govern the extent of their application under a given set of circumstances. The auditor's employment contract circumscribes his actions; these latter should be held strictly within such employment boundaries so that the problems thereunder will not be enlarged upon or be considered in any manner except in harmony therewith.

The auditor often experiences considerable difficulty in persuading a client that a certain course of action is necessary, since the usual client harbors an optimistic attitude toward accepting things at face value:

1. It is difficult to convince him that a cursory examination of the asset items is useless, especially where the accounts have been carried upon the books a long time, as for a number of years.

2. It is difficult to show him that his surplus, which he has nursed along for a period of years to a point of considerable paper prominence, may have been made possible by the manipulation of the asset accounts.
3. It is difficult to convince him that trusted employees who, for some reason, have a special interest in the financial showing of the undertaking (as receiving a bonus if profits reach a certain amount or who may profit by market fluctuations in the stocks and bonds of the enterprise) might be in a position to manipulate matters for their personal ends, and perhaps may have done so by overstating assets. A so-called trusted employee, because of the lack of supervision over his actions and the lack of suspicion pointing his way, usually is the one entirely responsible for manipulations and even peculations.

The entire subject of asset value verification revolves around the elementary principle of charge and discharge; every person who has anything to do with the business transactions may be involved in some way. The human elements in every undertaking of considerable size are both reputable and disreputable.

Various persons are charged or chargeable with asset values, and the auditor's duty is to determine how much; in each case, it is his duty to determine what are the amounts of the charges or of the chargeabilities, and what are the amounts of the discharges or dischargeabilities there against. It should be remembered that, at certain times, management representatives attempt to affix high special values to property items and that at other times they endeavor to show less values.

To do his work properly in connection with asset verification, the auditor should be equipped with two most important and vital traits:

1. Thoroughness. He must have the patience and doggedness to dig deep to the heart of the most tangled situations.
2. Discrimination. An auditor must distinguish between the essential and the non-essential, between the material and the immaterial. All kinds of documents, papers, and verbal explanations will be given him — some of value, and others representing merely an attempt to throw him off the right track or to influence his impartial judgment. Again, many things may be withheld in an attempt to have trans-

actions accepted on the basis of insufficient data or to have them lost sight of entirely.

Title to Assets. — Any impairment of the title to assets lessens their value for Balance Sheet purposes. The matter of title is of real concern to the auditor; it is necessary for him to trace all asset titles back to the origin of the transactions — as to informational display on Minute Books or in original entry records. His task hereunder is to determine whether:

1. Title rests in the person, firm, corporation, or trustees under audit.
2. Judgments, liens, hypothecations, etc., exist against the establishment of full title.

The accuracy of the booked total of every asset is questionable and challengeable. Hence, the auditor may trace as he sees fit, perhaps clear back to the original source of each component part, verifying both legally and commercially the purchase and negotiations of every kind having a bearing upon the matter.

Current Assets. — In some ways, the current assets are the most difficult to verify inasmuch as their character is so liquid. Basically, they are supposed to include cash and only such assets as are held to be converted into cash as soon as possible.

The general rule for valuing current assets is cost or market according to which is the lower at the date of the Balance Sheet. Since these assets are held for resale purposes, if the market price has dropped, and such fall is not a mere fluctuation, but seems to represent a decline more or less permanent then, in effect, a loss has been made on the purchase and this loss should be provided for. If goods, for example, were purchased at high prices, and subsequently the market dropped, with the apparent result that they cannot be sold in the following year at a profit, then the loss should be provided for at once, and this should be allocated to the year in which the goods were bought.

From the standpoint of a general audit, current assets never should be valued above cost price, since the effect is to take into account a paper profit — one purely fictitious and unrealized. On the other hand, this reasoning might be used to support the contention that current assets should not be written down where the market values drop below cost. But this seems in error since

it has become nearly axiomatic in practice that losses always should be anticipated, profits never. If provision is made for an estimated loss, and it develops subsequently that this estimate was in error and that, in fact, a profit resulted from the transaction, no harm has been done, and the following year will benefit in the amount that the previous year's profits were underestimated. If a profit is anticipated and is taken up as a credit before realization, then the estimated amount may have been disbursed to the proprietors, and upon its being found later that this was not a justifiable procedure — the transaction having resulted in a loss — it may be impossible to recover such overpayment; hence, the business capital is reduced by the amount of the past overestimation of profit.

Further comment upon the valuation of assets and the auditor's position relative thereto is taken up later.

Audit of Notes (Bills, Drafts, and Trade Acceptances) Receivable. — Upon the completion of the preliminary endeavors mentioned above in relation to cash, notes, securities, Minutes, etc., the notes receivable asset may be taken up for purposes of analysis and of scrutiny. Perhaps the audit proper of this asset may be delayed until the cash asset examination has been completed entirely but, in general, inasmuch as a considerable delay is evident between the time of sending for bank or other confirmations covering cash on deposit, notes and securities out, etc., and the receipt of these by the auditor, this method of approach seems fairly satisfactory.

As suggested before, the exact step by step procedure must be such that all connected with the auditor's staff on the assignment are kept efficiently busy. It might happen, for example, that considerable detail work with the inventories is done before anything further is contemplated as to notes receivable and securities beyond their physical count; again, the accounts carried therewith may not be audited until the usual analysis of the General Ledger accounts seems in order.

Inasmuch as fictitious notes frequently are used to cover defalcations, the auditor must determine with great care just how much auditing these will warrant; this depends upon the system of internal check in operation, and the volume of the notes encountered:

1. In certain lines, a large number is found.
2. In other concerns, the taking of notes is fairly infrequent.

But in any event, it seems that in his work on notes the auditor will make use of a formula which may be couched as follows: *Balance at the beginning* of the period, *plus new notes* received during the period, *minus notes paid* during the period *and notes dishonored* charged out of the account, *equals balance* at the end of the period.

It is the auditor's duty to ascertain to what extent this asset represents only unmatured notes from outsiders free from all liens.

The auditor should orient himself quickly as to which of the two following methods exist for recording notes receivable:

1. Notes Register as a memo record. This is not considered as a posting medium since each note is entered first in the General Journal and then a second record is made in an auxiliary book — the Notes Register. The Notes Receivable account shows the detail debits and credits for each note recorded.
2. Notes Register as a posting medium. This record carries the original note entries, postings being made therefrom to the Ledgers; it is a special Journal. The Notes Receivable account hereunder assumes the nature of a summary or controlling account.

The above covers in a general way, also, what are known as "trade acceptances":

1. Where these are of average volume, they need not be distinguished from notes.
2. Where their number assumes large proportions, and the desire exists to set out the item separately upon the Balance Sheet:
   a. A separate account may be carried for trade acceptances, and
   b. They may be recorded in the General Journal or in a special Journal.

If a considerable volume of notes is found, inquiry should be made as to the practice of taking them in that particular line of business.

Inspection and Verification of Notes (and Bills) Receivable. — Regardless of the size of the undertaking, the auditor, if possible, actually should inspect all notes and bills composing the total appearing in the accounts carried therefor, noting that they appear properly made out as payable to the concern, completed and stamped, and that they are not overdue. Perhaps a list is prepared of the notes as of a certain date — as date of examining this asset — or a listing as of the date of the Balance Sheet is produced to the auditor. A scrutiny is made of the list total to see that this agrees with the account balance shown in the General Ledger. It is this listing that may be extended into the form of the working sheet or schedule referred to previously. Frequently, a comparative listing as of the beginning and end of the period may be desirable for tracing purposes. The Notes Register balance must be agreed with the controlling account.

The character of each note should be investigated carefully to determine:

1. If drawn in the ordinary course of trade — for merchandise sold or for business transactions duly consummated
2. If drawn to cover special advances of funds not in the ordinary course of trade — accommodation notes or notes issued to friends

Paper of the second type is encountered all too frequently. Notes of, or those indorsed by, persons directly or indirectly connected with the business — employees, officers, directors, agents, and others — may be presumed to represent value when, in fact, little or no value exists; these should be explained satisfactorily. In other words, the consideration given for each note should be determined.

Each note should be valued upon its own merits where it is unusual to accept notes in that line of activity; to this end, the auditor should trace every one back to its origin. If he finds renewal notes, a complete history of each from the beginning should be prepared in writing; the mere fact that a note has been renewed often does not necessarily indicate a sign of weakness but, if renewals are considerable, a possibility exists that such is the case — and they should be viewed suspiciously.

If it is the custom of the trade to accept notes, the basic principles of valuing accounts receivable may be followed (see *post*); the percentage of loss will be based upon past experience in that line of business, except that past-due notes must be written off more rapidly than past-due accounts. If the audit is completed sometime subsequent to the date of the Balance Sheet, some notes outstanding as of Balance Sheet date undoubtedly will have matured; hence, the cash from these should be traced into the Cash Book and bank. By this means, any that have been dishonored or renewed will be discovered; in this event, careful inquiry should be made as to the reserve necessary to provide against possible uncollectible items.

The balance of the notes still outstanding — current at the time of audit — should be taken up with a responsible official, and inquiry made as to the adequacy of the reserve (if any) provided. In this connection, it may be desirable to refer to correspondence on file in order to determine their collectibility.

Notes which are in the hands of banks for collection, in transit, out as collateral, at branches, or in the hands of attorneys, should be verified by direct correspondence with the holders. Many auditors maintain that the only satisfactory method to pursue is to verify the genuineness of all notes by direct correspondence with the makers in order to uncover fictitious notes used to hide defalcations. But where the number of notes held is large, or where the client objects (as frequently happens), it may be impractical to verify them by this means. Even a physical inspection of all notes may not be practical, in which event a partial check may be all that can be attempted. If so, effort should be made to send out verification letters to a certain representative list of note makers; at least, a few months may be selected at random, and the note transactions thereof verified in detail. The auditor should govern himself accordingly in his report.

Where all of the notes, supposedly on hand, are not in the office, the most thorough verification possible, under the circumstances, should be made. Sometimes, it will be found that notes have been paid, the cash being in the mails. In writing to note holders, where the client's consent has been secured to do so, it is advisable to include in each letter a complete list

of the notes supposed to be held by them, since thereby more complete information will be received especially as concerns notes in transit, or cash in transit related to the notes.

All notes which should have been on hand on the last day of the audited period, and which do not appear in the schedule prepared as of examination date, must be traced as to disposition. Notes out as collateral reduce the available note assets of the enterprise; it seems advisable, therefore, to set out this item separately in the Balance Sheet. Post-dated checks should be treated as notes; they are bills of exchange.

Notes Receivable Discounted — Contingent Liability. — Discounted notes receivable must be taken into consideration; this may or may not raise a problem of considerable difficulty. These notes represent a contingent liability which may or may not be earmarked clearly in the records; frequently, it is lost sight of altogether. Basically, the auditor must understand how the bookkeeper has made his entries for them; for example, he might have credited them directly against the Notes Receivable account, or he might have entered the credit in a special account as Notes Receivable Discounted.

The contingent liability for discounted notes receivable must be shown upon the Balance Sheet, because it may have an important bearing upon the future solvency of the concern should the makers fail to pay at maturity. Notes discounted with a bank are verified by securing a certificate from the bank.

If a note has been dishonored and has gone to protest, depending upon circumstances, it may be charged back to the maker or payee (as customer); or it may be segregated from the rest, aged, and be set out as Notes Receivable Protested, with proper provision against possible loss.

Unmatured non-interest bearing notes, if their amount is considerable, should be carried into the Balance Sheet not in excess of their discounted amount.

Listing and Auditing Notes Receivable — Federal Reserve Suggestions. — Quoting from the Federal Reserve Bulletin, concerning a Balance Sheet audit for credit purposes, we find:

"A list of notes receivable outstanding at the end of the fiscal period should be prepared, showing the dates the notes are made, the customers' names, the date due, the amounts of the notes and the interest, if any, contained in

the notes. If discounted, the name of the discounting bank should be noted and verification obtained from the bank.

"The outstanding notes must be carefully examined with the notes receivable book, and with the list prepared by or produced to the auditor, the due dates and the dates of making the notes being carefully checked, and when notes have been renewed the original dates should be recorded. When notes have been paid since the close of the fiscal year, the cash should be traced into the books of the company, and, when they are in the hands of attorneys or bankers for collection, certificates should be obtained from the depositaries.

"When notes receivable are discounted by banks the company has a liability therefor which should appear on the Balance Sheet. Lists of discounted notes not matured at the date of the audit should be obtained from the banks as verification and their totals entered under 20 *a* (see Uniform form of Balance Sheet, *post*) if the cash therefor is shown as an asset.

"The value of collateral, if any, held for notes should be ascertained, as it frequently happens that the notes are worth no more than the collateral.

"Notes due by officials and employees must always be stated separately from customers' notes, as must also notes received for other than trade transactions.

"Notes due from affiliated concerns must not be included as customers' notes, even though received as the result of trading transactions. Affiliated companies' notes should be shown as a separate item of current assets or other assets (see Balance Sheet referred to, *post*) as the circumstances warrant. They may be fairly included in current assets if the debtor company has ample margin or quick assets (see form of Balance Sheet) over its liabilities, including such notes."

Account Analysis. — In auditing work, many accounts must be analyzed, particularly those found upon the General Ledger. When an account is analyzed, it is taken apart and its detail components classified so as to determine what the account contains. Account analysis seems to have five definite objects:

1. To prove additions of the General Ledger accounts. If an account is analyzed and the items therein are grouped according to the various classes of things they represent, and group totals added, the account is proved without the necessity of footing.
2. To see that nothing has been buried which has no right to be there.
3. To determine that the components have been posted to the correct account. An error here may be due to the fact that the bookkeeper has slipped in applying accounting principles, that he is ignorant of what the proper treatment should be, or that he has unintentionally made a posting to one account when he meant to make it to another.
4. To ascertain that the proper distinction has been made between capital and revenue; primarily, that expenses have not been capitalized.
5. To see that assets have not been written off the books when they should have been retained.

The last four points cannot be covered by a mere checking, as a general rule; hence, the analysis of an account cannot be done too carefully. Whatever the results may be, they should be expressed both clearly and comprehensively, regardless of the amount of time that may be consumed in securing such results.

Under practically every occasion for the analysis of an account, it is probably safe to assume that the auditor should plan to use one sheet of analysis paper for the debits and another for the credits. Such sheet should be headed up in the usual manner with name or code number of audited concern, period covered, and what the analysis is presumed to cover. The spread is from left to right across the page, as a rule, the first column for dates; next for posting references, next for amounts; and, lastly, for explanation. Not only should provision be made for showing the account balance per Ledger, but a summary of the components should be included.

As soon as a transcript of a Ledger account has been prepared properly on the analysis sheet, it is necessary to find out what each item therein represents. In part, a hint thereof may be secured from the Ledger account explanations, provided the latter are shown in the Ledger (not apt to occur except in a small concern). On a new assignment, all items must be traced back to origin, and be analyzed — particularly as to the property accounts. Inasmuch as postings are made monthly, as a rule, and each one represents a number of items and a variety of detail, one amount shown in an account may be composed of a number. It is not sufficient, for example, to trace a property accession into the Voucher Register and stop at that point; the vouchers covering each component must be secured from the files (usually by an office clerk) and each examined to determine what it represents.

When a schedule is completed, a summary should be made of

the analysis, this being placed preferably somewhere on the top sheet. If an analysis covers a number of pages, such summary may be made upon a separate sheet which is laid on top of the pile.

Next, the propriety of the entries should be scrutinized to determine what adjustments are in order; these latter may be indicated or be shown directly on each schedule, being numbered consecutively; or they may be earmarked and the necessary entries placed upon another sheet.

The accounts requiring analysis depend upon the particular assignment. Ordinarily, all will not be analyzed; the property accounts, and the expense accounts of fair size, usually, are the ones requiring such scrutiny. Most of the others are proved out automatically as the work progresses.

Notes Receivable Account Analysis. — In order to illustrate the principle of analysis, the following simple account is offered:

Notes Receivable

1923					1923			
Nov. 16	A. Smith	J. 10	1,000.00		Nov. 27	A. Smith	CB. 30	300.00
19	B. Jones	J. 13	800.00		29	C. Howard	CB. 32	150.00
26	C. Howard	J. 15	500.00		Dec. 2	A. Smith	CB. 34	200.00
Dec. 3	D. Stokes	J. 19	1,500.00		4	B. Jones	CB. 36	300.00
14	E. Tuttle	J. 20	900.00		15	D. Stokes	CB. 40	700.00
30	A. Smith	J. 27	500.00		30	A. Smith	J. 27	500.00
					31	Balance		3,050.00
			5,200.00					5,200.00
1924								
Jan. 1	Balance		3,050.00					

It should be noticed that the form of analysis sheet illustrated differs from the usual type suggested above in that the debits and credits are not listed in separate schedules.

Notes Receivable Conclusion. — Under either a Balance Sheet or a detailed audit, it is beyond one's ability to determine in advance just what shall be done in reference to the notes receivable. From one point of view, a certain indicated procedure may appear satisfactory; from another, the same attack may be subject to severe criticism. In general, for illustrative purposes, the following suggestions as to differentiation may be made:

A and B

Analysis of Notes Receivable

November 16 to December 31, 1923

		1923	Folio	Debits	Credits			Balance
A. Smith:	Note Given	11/16	J. 10	1000 -				
	Payments	11/27	CB 30		300 -			
		12/2	CB 34		200 -			
		12/30	J. 27		500 -	{Cancellation and		
	Renewal	12/30	J. 27	500 -		{Renewal		
	Balance							500 -
B. Jones:	Note Given	11/19	J. 13	800 -				
	Payments	12/4	CB. 36		300 -			
	Balance							500 -
C. Howard:	Note Given	11/26	J. 15	500 -				
	Payments	11/29	CB. 32		150 -			
	Balance							350 -
D. Stokes:	Note Given	12/3	J. 19	1500 -				
	Payments	12/15	CB. 40		700 -			
	Balance							800 -
E. Tuttle:	Note Given	12/14	J. 20	900 -				900 -
			Total Debit →	5200 -	2150 -	← Total Credit	Balance → (See T. Balance)	3050 -

Summary

	Debits			Credits
A. Smith	1000 -			300 -
	500 -			200 -
				500 -
		1500 -	1000 -	
B. Jones		800 -	300 -	
C. Howard		500 -	150 -	
D. Stokes		1500 -	700 -	
E. Tuttle		900 -	—	
Total Dr.		5200 -	2150 -	
Total Cr.		2150 -		
Balance 12/31/23		3050 -		

1. Balance Sheet audit:
   a. Examine and schedulize.
   b. Compare notes scheduled with book record — Note Register and General Ledger.
   c. Secure direct confirmation from maker; or proceed otherwise to uncover notes received but not recorded.
   d. Secure bank confirmation as to discounted notes or notes out for collection.
   e. Calculate accrued interest and compare with General Ledger.
   f. Provide necessary adjusting entries — notes past due, uncollectible, etc., and reserve.
2. Detailed audit:
   a. Inspect and schedulize.
   b. Verify total on hand against book record, and against control; or ascertain disposition.
   c. Check all entries from note record to Customers' Ledger.
   d. Check all transactions into Cash Book.
   e. Cover all variations from the ordinary.

Securities — Investments. — Securities, like notes receivable, should be counted as soon as possible after an audit is commenced and, where possible, on the same day the cash is counted; all should be counted at one time or sitting to avoid having the securities presented twice.

Stocks and bonds owned, mortgages receivable, and other securities should be verified by actual inspection. These documents may represent:

1. Temporary investments of cash surplus
2. Permanent investments
   a. Sinking or other special funds
   b. Stocks of subsidiary companies

In view of the above, the present discussion is divided into three portions:

1. Stocks of subsidiary companies
2. Investments
   a. Interest
   b. Dividend
3. Sinking fund assets

Where investments are numerous, the auditor should have presented to him a schedule of some sort, showing full title, book value, and market value as on date of the Balance Sheet.

Stocks of Subsidiary Companies. — These contain an element of control, or a material interest in other enterprises. Their ownership carries more or less value to the holder beyond that of a direct return; hence, they should be classed as fixed assets rather than as current. Under similar conditions, the same treatment should be accorded bonds. The financial books should be scrutinized carefully, in addition to the physical scrutiny given the documents hereunder, if a complete verification is desired. In case the par value of these securities does not appear upon the financial records, the auditor must avail himself of contracts, Balance Sheets, and other subsidiary documents and records to determine what is such par value.

Too great care cannot be exercised in verifying this asset; yet the auditor should have it understood clearly just how far he is to go. In a full verification, the contracts, the financial books of the subsidiary companies, etc., must be scrutinized closely; if only a partial verification is in order, the extent of the work performed should be set out carefully in the report so that the auditor will not assume responsibility for that which he has not investigated.

The principles involved in stating the values of stocks are presented in a later chapter on Proprietorship; hence nothing further is offered at this point.

Interest Investments. — These carry a fixed rate of return which accrues as time passes. They may be of two kinds:

1. Secured:
    a. Bonds secured by mortgage or trust deed upon:
        i. Real property
        ii. Personal property
        iii. Both real and personal property
        Most bonds encountered will be coupon-bearer bonds
2. Unsecured:
    a. Long-time notes held for an interest return

This type of investment is subject to fluctuations in the value of the principal owing to market conditions so that, when a sale is made, there may be either a profit return or a loss. The carrying value of interest bearing securities may be set out as under:

1. If held permanently for the interest return thereon, the carrying value at maturity should equal par; hence, the nominal interest received must be adjusted periodically:
    a. If purchased at a premium, the premium should be written off proportionately against the nominal interest return over the life of the security.
    b. If purchased at a discount, the value must be written up to par as an addition to the interest return over the life of the security.
2. If held for speculative purposes, as where conversion takes place from time to time, values may be stated at cost or market, whichever is lower, although cost seems preferable (with a reserve provided to cover shrinkage; or a Balance Sheet footnote as to the amount of the shrinkage) — the better to determine profit or loss when a sale is made. Where these investments constitute the stock in trade, as in an investment house, values are to be stated at cost or market, whichever is lower.

If the physical verification of securities cannot be made at one time, the bonds as verified should be made up into packages and each package sealed, or the packages should be placed in a special vault and the vault sealed, so that they cannot be tampered with after verification until the task is completed.

The act of physical verification of bonds should determine the following:

1. That the proper corporate officers have signed the bonds and that the corporate seal is attached.
2. If the mortgage requires that the bonds be signed by a registrar, the registrar's certificate, usually on the back, should be executed properly.
3. That all coupons maturing on subsequent dates are attached; if not, they should be produced for inspection; otherwise, good delivery is impossible.
4. That the bonds are to bearer. If the bonds are registered, they should be negotiable:
    a. By an assignment in blank, or
    b. By being in the name of the owner for whom the audit is made.

5. That no alterations or defacements are on the bond which will affect market value. A defaced bond cannot be dealt with on the Exchange even though listed. Since a new bond is most difficult to secure, this element is important in determining the value of a bond.
6. The same care should be observed with coupon notes as is necessary in the case of a bearer bond.
7. Principal or interest past due must be particularly investigated. If coupons are overdue, it may be because:
   a. The holder has failed to present them, or
   b. The obligor corporation cannot pay.
   In either event, a comment upon conditions should be made in the report.

Mortgages receivable may be included among investments. If only a portion of a mortgage is held, a bond verification is present; hence, the comment below refers to the case where a whole mortgage is represented by the asset. Although the verification is somewhat similar to that above, the following points are of interest:

1. Determine that the mortgages have been recorded in due and regular form; also, that the payments thereon have been recorded. Unrecorded payments do not lessen the lien, at least legally; hence, the amount thereof may be deducted on the Balance Sheet from the mortgage receivable, and a footnote used to show the unrecorded payments.
2. Determine if any policy of guaranty exists.
3. Determine that notes, mortgage, and insurance policies are in order.
4. Determine whether or not all the taxes have been paid upon the pledged property.
5. Become familiar with the terms, interest payments, margin of security, etc., and govern self accordingly.

Frequently, a Mortgage Register holds the detailed data relative to each mortgage; if not, such investment perhaps is found charged to an asset account in the General Ledger.

Dividend Investments. — The return from dividend investments (stocks) does not accrue with the passing of time since subject both to profits actually earned, and action by the Board of Directors (only rarely are directors bound to declare and pay a

dividend). If the stock is guaranteed, the return is more fixed in nature than usual, provided the guarantor is financially responsible. A dividend investment is not held, in general, for control purposes since therewith it is unusual to have control beyond the incidental voting power that the usual type of this kind of security carries.

This type of investment is subject to fluctuations in the value of the principal owing to market conditions so that, when a sale is made, there may be either a profit return or a loss.

Dividend investments should be examined as to the following:

1. That the certificates are executed properly
2. That they are either assigned in blank (making them negotiable) or that they are made out in the name of the undertaking being audited
   a. A proper assignment in blank does not necessarily mean that the security is negotiable. The Exchange requires that the signature of the former owner must be guaranted by an Exchange house or member. The former owner's signature must agree exactly with his name as shown on the face of the certificate.

Certain financial papers publish the declaration and payment of dividends upon both listed and unlisted active stocks. The auditor should have access to a file of these papers to establish facts as to such declaration and payment. If stocks are not quoted on the Exchange or in the financial papers, considerable difficulty may be experienced both in establishing values and in determining the declaration and payment of dividends; in such case, recourse may be had to the following sources:

1. The officers of the respective corporations whose securities are held
2. Dealers in unlisted securities
3. Printed reports and financial statements of the respective corporations

Recent prices at which shares have been transferred is not necessarily a true index of value since, if no free market exists, the purchase consideration may not represent the actual value. In any event, such information is not sufficient; the auditor

should ascertain what dividends have been paid recently, and if he is able to scrutinize a copy of the last Balance Sheet of each company concerned, he has some basis upon which to form an opinion.

Working sheets for stock and bond securities have been illustrated in Chapter III.

General Points of Interest Concerning Securities. — Certain points of general application to securities of both classes mentioned above, which might be of interest in the present connection, are offered below.:

1. Separate listings should be prepared of all securities out as collateral, and these should be verified by correspondence.
2. If any securities are purchased after the end of the period under review, such purchases should be traced into the Cash Book.
3. If any securities are sold after the end of the period, the receipts received should be traced into the Cash Book.
4. If any securities have been obtained as consideration for services rendered, whatever outlay has been incurred in connection with such services should be charged to the particular investment as a cost thereof. If no such expenses or outlay exist, an account may be opened but without considering any cost as existing. When sold, the amount realized may be credited to the particular account, in which event the profit or loss realized shows up and may be written off.

Investments on the Balance Sheet. — If a Balance Sheet is supported by an investment schedule, a separation may be made therein between interest and dividend securities.

Where market value is less than cost, provision may be made for the reduction in value by means of a valuation reserve account which is set up and then reversed as of the beginning of the new period. The handling of this account is similar to that used where the market value of inventories is less than cost (see *post*). Temporary market fluctuations may be disregarded entirely; but the question remains, as to when an exceptional circumstance arises under which it is safe to assume that a mere temporary fluctuation exists.

In all cases, the basis of valuation should be stated in the Balance Sheet — as: "at cost," "market price," or "at cost less reserve." Further, in this connection, subdivisions may be desirable the better to secure a fair idea of their nature. On no account would it appear proper to show investments at an above-cost valuation which requires a Profit and Loss credit. If the fall in value seems to be rather severe, it may be desirable to comment thereon in the report.

Where investments are purchased from idle funds, they may be found as current assets; where they represent complete or partial holdings in subsidiary concerns, they may be shown among the fixed assets; sometimes, investments are shown under a separate heading, say, between the current and the fixed assets.

Sinking Fund Assets. — The auditor should familiarize himself with all of the provisions governing the establishment of the sinking fund and its operation, and determine whether or not the transactions conform to them, reporting accordingly. A sinking fund is established usually in accord with contracts or the provisions found in trust deeds or mortgages securing the payment of a debt.

Since the fund consists of assets, the verification of the actual sinking fund consists of verifying the separate property items therein contained:

1. Cash (this may be verified by the principles advanced previously)
2. Securities (these may be verified by the principles above shown)
3. Etc. (unusual to find)

If the fund consists of cash on deposit, securing a certificate from the depository stating the amount on deposit ought to be sufficient so far as the actual amount of the fund is concerned. Interest accretions to the fund should be verified, and all credits to the fund to which the company is entitled should be ascertained. If the fund contains retired bonds, or other securities, in the hands of a depository, it is sufficient usually to accept the certificate therefrom to the character and the amount of the securities so held.

In case the fund is dependent for its accumulation upon:

1. Net profits, or
2. Amount of production (output)

such profit or output must be determined to secure a basis upon which to calculate what the amount of the fund should be, and all necessary steps should be taken to establish the accuracy of this amount. In other words, the auditor establishes the facts necessary to permit him to certify as to what should be the amount of the fund, regardless of its actual contents. The character of the examination made should be extremely searching, since laxity in the handling of a sinking fund may be a cover to criminal practices.

Listing and Auditing Securities: Federal Reserve Suggestions. — The following is taken from the Federal Reserve Bulletin:

"Under this caption must be listed securities in which surplus funds of the company or firm have been temporarily invested and which are considered available as 'quick assets,' *i.e.*, can be turned into money in time of need. Where stocks or bonds represent control or a material interest in other enterprises, the ownership of which carries more or less value to the holder outside of the return thereon, they should be considered as fixed assets.

"A list of investments should be prepared showing —

The dates of purchases
Descriptions of the investments
Par value of the investments
The denomination of the shares
The number of shares or bonds owned
The total capital stock of the various companies
The amounts paid for the investments
The interest and dividends received
The market values of the investments
The surplus or deficit shown by the Balance Sheets of the companies where no market quotations are available
If hypothecated, with whom and for what purpose

"This list must be compared with the ledger accounts concerned and the total of amounts paid according to the list must agree with the balance of the investment account or accounts.

"The securities must be examined by the auditor in person or he must secure confirmation of their existence from those who hold them as collateral. Those in possession of the company must be counted and examined as soon as possible after the audit starts, and all of them must be submitted to him at one time. It is much more satisfactory to see the actual securities than to verify cash receipts and other evidences therefor after the audit has progressed some time.

"Certificates out for transfer must be verified by correspondence.

"Where the market values of securities are less than the book values, save

where the variation is so small as to be trifling, a reserve for loss in value on the Balance Sheet date must be set up.

"Care must be taken to see that the certificates are made out in favor of the company, or that they are endorsed or accompanied by powers of attorney when they are in the names of individuals.

"Coupons on bonds must be examined to see that they are intact subsequent to the latest interest payment date.

"The investment schedule must show that the total interest and dividends receivable by the company have been duly accounted for; the income from the investments shown in the Profit and Loss account must be in accord with this schedule.

"When market quotations can not be obtained for investments, the Balance Sheets of the companies in which investments are held must be examined so that the auditor may form an idea of their value.

"In verifying purchases of stock exchange securities the brokers' advices must in all cases be examined in connection with the verification of the purchase price.

"Investments in deeds and mortgages must be supported by both the mortgages and insurance policies, and, furthermore, it must be shown that all assessed taxes on the property have been duly paid, that the mortgages have been properly recorded, and that the insurance policies are correctly made out to the company.

"If any of the securities have been hypothecated the fact and amount (book value) must be stated under 20d of the Balance Sheet (see *post*)."

CHAPTER VII

AUDIT OF THE ASSET ACCOUNTS (*Continued*)

ACCOUNTS RECEIVABLE

TRADING TRANSACTIONS RELATED TO SALES

Introduction. — The close relationship between the sales records and the accounts receivable seems sufficient reason for commenting briefly upon the audit of the trading transactions of sales, sales returns, etc., in connection with the asset of accounts receivable. This portion of the present chapter refers more especially to the detailed rather than to the Balance Sheet audit.

System of Accounting and of Internal Check. — The extent to which the accounts receivable may be manipulated seems practically without limit; for example:

1. The names used on certain notes receivable may be fictitious, but may have been selected so as to appear strikingly similar to certain names of customers carrying open accounts; this deception will not be detected without the exercise of more than ordinary watchfulness.
2. Accounts may be carried as current when they are not that; yet, by certain manipulations, the Ledger apparently will bear out the contention of their being current in character.
3. Etc., etc.

The system of recording sales from the time an order is received until the customer is charged and cash collected should be determined accurately by the auditor. Although each class of enterprise has its own particular system, the results secured, with the intervening checks and balances, should be satisfactory.

The two factors covered by the heading of this section govern, generally, the extent to which the auditor should go in the accounts receivable examination. A desirable system of internal check over this angle, as before, is more apt to be encountered in

the larger organization than in the smaller one, inasmuch as, ordinarily, " the risk of errors and omissions decreases in direct proportion to an increase in bookkeeping." A dangerous situation arises in a small or moderate-sized business where one bookkeeper (perhaps aided by an assistant) constitutes the entire office force.

Sales on Credit. — A proper record of goods sent out should exist, and this should be examined in connection with whatever represents an Order Register, the prices and extensions being checked more or less as circumstances seem to justify. If the nature of the audit be such that all the detail requires checking, the Sales Books should be footed, all forwarded amounts checked, and the monthly totals traced into the General Ledger. On the other hand, if the volume of transactions is considerable, and the system of internal check over the Sales Ledgers adequate (see *post*), it should be nearly sufficient for the auditor to test the Sales Book footings. But under any situation, all amounts forwarded ought to be checked since this in itself seems to constitute a most excellent test.

Sales of capital assets — as old machinery, etc. — infrequently are handled as regular sales. Where discovered, the sales total must be analyzed so that credits of this nature at cost may be sent to the asset accounts involved; otherwise, the period's income will be incorrect.

If suspicion arises that sales are questionable, as where entries have been made which inflate profits, the record of sales orders plus all available correspondence thereon may be scrutinized. Also, the shipping records may be examined to determine that the goods in question actually have been shipped out. The application of this test to the facts recorded near a period's close should uncover sales belonging to that following, treated as actual sales in the period being audited, although the goods were not shipped and may be found as part of the inventory on hand — creating an untrue profit.

Cash Sales. — It is of primary importance that an efficient method of handling cash sales exists, inasmuch as where such is not the case, the auditor has no reliable means whereby their accuracy can be verified; the only conclusion possible seems for him to refuse any responsibility in connection therewith. He may

suggest that a proper procedure be installed. The vouching of cash sales has been commented upon previously in connection with cash receipts.

Sales Returns. — The method of handling these should be inquired into. The summary record carried therewith should be footed and the totals be traced into the General Ledger. It seems advisable, also, to test a portion of the entries against the receiving records and, as to large items, reference may be made to correspondence. All credit memos should be approved and initialed properly.

Sales Allowances. — Careful scrutiny should be made to ascertain that these are all in order, since a most common method of concealing cash peculated is to make fictitious entries of allowances granted. Credit slips to cover should be authorized and initialed properly. Entries, especially those of consequence, should be tested against correspondence or whatever other evidence is available. Footings should be checked, and totals traced into the General Ledger.

Sundry Items Treated as Sales in Error. — Goods out in the hands of the trade on " sale or return " but unsold on the date of the Balance Sheet do not represent sales; their cost price with perhaps a percentage deduction for possible damage should be part of the stock inventory. No credit should be taken for profit on uncompleted sales.

Unless these transactions are so recorded that a ready determination of their amount is possible from a separate booking, they may be handled as regular sales, in error. If so, a schedule may be demanded of goods in the hands of customers; if the separate customers' accounts cannot be adjusted in relation thereto, an adjustment may be made in total by which the Sales account is charged and the Customers' Control credited.

The same principle of non-anticipation of profits should be followed in connection with goods sent out on consignment. Inasmuch as consignment accounting on the part of the consignor may be entirely in error — as well as presenting certain features of difficulty — the auditor should make a most careful scrutiny of the consignment situation. Since consigned goods, in general, are not invoiced at cost price, but at an estimated selling price — either for the purpose of insurance or so that the consignee

may not know the exact cost price of the goods — it is common practice to find goods consigned treated as ordinary sales, being passed through the regular Sales Record. In such event, the auditor should ascertain that the accounts are adjusted properly, and that the consigned goods yet unsold are included in the inventory at a proper valuation.

On the other hand, where goods are received on consignment, for sales purposes, the auditor should make certain that sales therefrom are kept separate from ordinary sales, and that the total thereof is not included in the sales account. Also, the consigned goods on hand should not be included as part of the stock belonging to the business. An inspection of correspondence, contracts, etc., will cast light upon the terms of the arrangement in force. At times, a statement of account should be secured from the consignor in order to verify the existing balance; usually, the balance thereon reported requires reconciliation with that shown by the client, because of items existing not yet taken up by the other party.

No profit should be anticipated in connection with sales for future delivery, even though a valid contract may be in existence, and even though the buyer has paid cash down in advance. Only those goods to which title actually has passed as of Balance Sheet date should represent sales. Even if goods are ready for delivery on Balance Sheet date under contracts of this type, it seems best to treat them as stock on hand as of such date, and to value at cost. It would seem that any course contrary to the above is not the most prudent one to adopt. The excess paid in by the customer in advance should make him a creditor to the extent of such amount.

Illustrative Audit Plan: Sales, etc. — A portion of an audit plan which may be considered as fairly representative of the possible steps in auditing sales, etc., as contemplated to this point appears as under:

1. Sales — Sales Book:
   - *a.* Test-Check additions: total and discount columns, cross footings, distributions.
   - *b.* Check postings to General Ledger or to Sales Recapitulation.
   - *c.* Test-Check postings to Sales Ledger.

d. Test-Vouch shipping slips.
e. Analyze sales.
f. Secure executive approval of credit allowances.
g. Take out consignment sales.
h.

2. Sales Returns:
a. Test-Check additions.
b. Check postings to General Ledger.
c. Test-Check postings to Sales Ledger.
d. Secure executive approval therefor.
e.

3. Raw Material Sales:
a. Test-Check additions.
b. Check postings to General Ledger.
c. Test-Check postings to Sales Ledger.
d. Test-Check postings to Contract Ledger.
e.

Internal Check and the Sales Ledgers. — Inasmuch as defalcations frequently are concealed by fictitious entries, the auditor should determine the extent of the internal checks against the Sales Ledgers, the inquiry being made along the following lines:

1. Control of cashier over Sales Ledgers, or over records of original entry other than his Cash Books. If any exists, the possibilities for concealing fraud are many and the auditor, as a result, must exercise great care.
2. Use of controlling accounts as a means of securing a separate proof over the total balances in the Sales Ledgers. Controlling accounts never should be under the charge of Ledger clerks.
3. Extent to which the Ledger clerks check their own work. In a small concern, no outside checking may exist; in a large business, other clerks should do this.
4. Handling overdue accounts, as to their collection.
5. Handling of returns, allowances, etc. (see *ante*).

Verification of Postings. — In the absence of a satisfactory system of internal check, as where the transactions are not too numerous, it may be advisable to check all postings. If this cannot be done, because of impracticability, it would seem that more

attention should be given to the credit postings than to the debit entries, inasmuch as fictitious credits are more apt to be made in an attempt to conceal defalcations than others. Cash Book debits covering cash received and discounts given should be checked out. Any discounts of size taken after the term of credit has expired should be scrutinized. Also, entries from the Note Register, Returns and Allowances Books, etc., should be checked so that, eventually, every credit item in each account is ticked.

Where the internal check system is good, and the Ledgers many, the postings need only be tested: all of those in one particular Ledger may be completely checked out, or certain accounts in the different Ledgers may be gone over in their entirety. Where an audit is made from year to year, in the course of time all Ledgers should be covered in this manner.

Verification of Balances. — Unless the actual accounts representing the individual balances are scrutinized — as by being checked from the face of the separate Ledgers onto the various Ledger abstracts — and the abstracts footed, it seems difficult to imagine that a proper verification has been made, regardless of the system of internal check in force. Perhaps the only procedure left for the auditor in this connection, in view of the fact that it is not customary to close each account as of Balance Sheet date and bring down each existing balance, or not ordinarily possible for him to request each balance to be inserted at the side of the respective accounts, is to draw off each balance himself in order to have somewhere a permanent record thereof as on Balance Sheet date, the total of which may be checked against the control. It may be, however, that he will elect to check out an abstract or list which has been handed to him by the bookkeeper (see *post*).

As each balance is being determined for checking purposes, thought should be given to its composition — whether it represents particular items of goods or is an accumulated balance. In the latter event, the question should be answered satisfactorily as to why the account is open; if due to errors or disputes, some adjustment may be necessary, or the amount may require consideration when the matter of an adequate reserve is approached (see *post*).

No trade discounts should be found in the balances; if en-

countered, adjustments are necessary to reduce to what properly is payable. Goods out on sale or return, on consignment, etc., should not be forgotten.

Accounts Receivable Components. — Only amounts carried upon open account due from customers, the result of *bona fide* sales, should be considered under the general caption of "accounts receivable." Many items characteristically different are often included in the accounts receivable total in error. Items of a different origin should be allocated elsewhere to prevent possible abuse and to furnish the Balance Sheet reader with the information to which he is entitled. If assets at all, these separate items should be listed separately, be aged separately, and be approved separately — where necessary — by some responsible official.

The components of accounts receivable may consist of some or all of the following:

1. Trade debtors
2. Advances to officers and employees
3. Amounts due from employees
4. Consignment accounts
5. Accrued items receivable
6. Advances made in connection with future purchases
7. Etc.

Accounts Receivable Control Not Used. — Frequently, no Customers' Ledger controlling account exists. When this is true, a most useful audit check is secured by constructing one from the totals secured from the Sales Book, Cash Book, etc.:

1. Initial balance, beginning of period
2. Add sales for the period (per Sales Record).
3. Deduct settlements and adjustments during period (per Cash Book, Return Sales Book, Journal, etc.).
4. Final balance, end of period

This set-out proves, by totals, that all items have been included in the accounts receivable.

The above construction procedure is similar to that which may be looked upon as a detail audit formula for accounts receivable; this may be stated roughly as:

1. Balance as of the beginning of the audit period.
2. Add total credit sales during audit period.
3. Deduct total remittances from customers during the audit period in cash or notes receivable, sales discounts properly taken, allowances correctly authorized, return sales properly approved.
4. Balance at end of period.

Illustrative Audit Plan: Accounts Receivable. — In accord with the ideas advanced previously, a typical audit plan, of general character, applicable to accounts receivable, may be as given below. As it stands, however, a strain of incompleteness seems evident because of the relationship of accounts receivable to the sales records, etc.:

Accounts Receivable:

a. Prepare name list. }
b. List by machine. } Check with control
c. Age accounts — schedulize. }
d. List credit balances separately.
e. Circularize customers to verify.
f. Check debtors' replies.
g. Check past-due accounts with credit man to determine collectibility.
h. Separate trade accounts from officers' accounts, etc.
i. Determine amounts pledged as loan security.
j.
k.

Preparing and Checking Accounts Receivable Schedule. — This has been commented upon briefly above. Usually a schedule of open balances is submitted to the auditor which is presumed to support a total displayed in the Balance Sheet and to be in agreement with the General (or Private) Ledger controlling account over the Customers' Ledger; if no such abstract is submitted, one should be prepared.

This schedule of customers' accounts, as prepared, first may be worked upon as follows:

1. Check against the respective accounts in the detail Ledger or Ledgers — to prove the account balances.
2. Any charge items of even amounts in the customers' accounts should be scrutinized carefully, and a representative

list thereof should be the subject of a detailed examination to make certain of their correctness.
3. Verify footings.
4. Scrutinize all open balances for items which have been in existence a long time.
5. Pull out all account balances of officers and employees, consignment account balances, credit balances, etc. Credit balances should be totaled separately, or at least this treatment should be accorded the large items (see *post*).
6. Scrutinize closely all non-cash credits in each account.
7. Age (see *post*).
8. Check against the amount shown in the controlling account upon the General Ledger, and against the amount shown in the Trial Balance or in the Balance Sheet if the latter has been prepared by the office — to prove total.

Frequently, also, the Accounts Receivable Ledger is checked against the cash receipts upon the Cash Book, against the Note Register, and against the General Journal. All credits from the General Journal should be examined closely and, usually, these credits should not be passed until they have been approved by one of the principal officials who knows whether or not such credits are proper. Generally, these cover allowances and similar items.

Branch Customers' Accounts. — These should be agreed with the main office Ledger. In some instances, the auditor verifies these accounts personally; in others, probably he will accept the confirmation or certificate of the branch manager thereon. All schedule sheets thereof should be footed and checked.

Accounts Receivable Other Than Customers. — Amounts may be included among the accounts receivable which represent something other than amounts due from trade customers:

1. A special loan or advance to an officer of the concern, or to an employee or affiliated company should not be buried with the ordinary trade items of accounts receivable; such extraordinary items should be shown separately upon the Balance Sheet. Loans to officers frequently develop into misappropriation of funds as when, subsequently, they are unable to repay; loans to officers are a common practice even though the company never is under obligation to make such advances and thereby lose the use of money in carrying on the purposes of the organization. Sometimes,

separate Ledgers for officers' and employees' accounts are used. If doubtful as to who is an employee, one may question a bookkeeper of the Sales Ledgers to advantage. Employees' loans should be approved by an official; loans to officers should be authorized in the Minutes of the Board of Directors. In connection with both classes, the auditor should inquire as to the possible date of payment. If employees' accounts represent stock or bond subscriptions:

   a. Count the securities, or inspect the subscription lists.
   b. Test receipts, totals paid, and balances due.

2. If goods are sold on consignment, it may be that they have been treated as sales, and the offsetting charges made to accounts receivable. They should be treated as part of the inventory until sold by the consignee. Consignment policies and procedure should be understood.
3. Returned purchases at times are charged to accounts in the Accounts Receivable Ledger where a voucher system is in operation, since no Ledger accounts are carried with creditors. These items must be separated from the accounts receivable because they do not represent customers' activities, being in the nature of offsets to liabilities.
4. Certain accounts receivable will have credit balances, these usually representing prepayments. Such items should be segregated carefully and be set up on the Balance Sheet as liabilities:

   a. Under the heading of accounts payable, or
   b. As unearned income

   depending upon the nature of the items. Some auditors, where the credit balances total only a small amount, consider them as a deduction on the asset side; this does not seem to be the correct treatment. A clear explanation should be secured as to why they exist.
5. Suspense accounts.
6. Claims for adjustment against transportation companies.
7. Advances to subsidiaries. These may not even be current assets. If the subsidiary used them for construction purposes or to make good operation losses, they ought not to be looked upon as current assets. Their true character may be ascertained only by tracing them into the accounts of the subsidiary. At any rate, they should be stated separately.

A creditor's account with a debit balance caused by an over-payment or a return of goods does not represent a reduction from the total accounts payable; it represents a special account receivable to be set out separately on the Balance Sheet.

The above items, and others which may be classified similarly, should be scheduled separately, nature and age determined, and proper approval of them secured; further, they should be explained fully in the auditor's report. It may be said, in general, that if of sufficient size, a separate inclusion in the Balance Sheet is in order; officers' and employees' advances, usually, must be thus shown.

Ageing Accounts Receivable: to Determine Collectibility. — The accounts receivable should be inspected further with the idea of determining what portion might be collected and, in reaching a decision hereon, it may be necessary for the auditor to examine each separate account. Ordinarily, one which is long overdue should be looked upon with suspicion, even though under certain circumstances it may be as good, if not better, than one that is not overdue, representing only a slowpay customer.

A proper accounting system should handle and control the work in connection with accounts receivable so that overdue amounts show up automatically; these may be taken care of by a particular department in which letters, contracts, memos, etc., are found on nearly every account of importance. Under such a condition, the necessary interpretative facts are in a form available to aid the auditor in determining collectibility and thereby expedite his work.

Two general methods of inspecting the accounts receivable may be summarized as under:

1. Method probably most common and practicable:
   - *a.* Pass rapidly from one account to another without a minute inspection of the items.
   - *b.* Note for fuller investigation:
     - i. Overdue accounts
     - ii. Accounts that seem out of the ordinary and examine underlying circumstances in connection with a consultation with the bookkeeper or credit man

2. Method uncommon but thorough (laborious):
   - *a.* Draw the accounts off on a schedule arranged with columns to show items:
     - i. Not due
     - ii. Overdue less than thirty days
     - iii. Overdue thirty to sixty days
     - iv. Overdue sixty to ninety days
     - v. Overdue ninety days to six months
     - vi. Overdue six months to one year
     - vii. Overdue more than a year

Ageing accounts by months, and schedulizing those past due is extremely helpful when verifying the allowance for doubtful accounts.

In preparing this schedule, the auditor should watch for old unsettled invoices where later items in an account have been since paid. Beyond a doubt the old invoice is in dispute and never will be paid in full; such condition, however, may be caused by duplicate charges, by returned goods not credited, and by allowances still due customers, and this means that a conclusion should not be reached without knowing the exact facts. Further, where such conditions are found, care should be observed in assuming that the credit department is at fault in granting further credit in the face of a past due balance; the granting of credit largely is a matter of judgment with factors influencing a decision that should be of no concern to the auditor. Ordinarily, if a credit manager were thus arbitrarily circumscribed in his actions, a condition of too strict accountability would be found for practical purposes. Nevertheless, every account of this kind should be circularized by the auditor by sending the debtor a statement of his account with a request that this be verified and returned direct to him.

Valuing Accounts Receivable: General Conditions. — The auditor's capacity will be taxed to the utmost in reaching a decision as to a reasonable valuation to be given the accounts receivable. Perhaps the following summary of the process involved answers the purpose inasmuch as, of necessity, this will vary according to the particular auditor:

1. The estimate, primarily, is made from the records, tempered by the auditor's judgment.

2. Such estimate will be made after he has more or less superficially at best analyzed the accounts into the three groups of good, doubtful, and bad, taking into consideration the available information at hand (probably more or less superficial as well) in the way of correspondence and reports of rating agencies, plus whatever information can be procured from supposedly reliable persons in the same lines of business, officers of banks and of trust companies, and from a legitimate knowledge of the trade.

A study of the correspondence files, of the shipping records, of the Returned Sales Journal, etc., should produce much valuable indirect information. If a customer has failed to make a prompt settlement, the correspondence that would result as a natural sequence should be obtained and read. It may be necessary, in this connection, for the auditor himself to "pull" the letters from the files; if so, he should have a knowledge of the particular filing system in use. In this connection, the auditor should remember the possibility exists that the correspondence he wants may have been removed from the files for the express purpose of not acquainting him with the actual facts that he desires to secure.

Further, it would seem that practically no reliance can be placed upon the management's estimate of the worth of the customers' accounts. This seems true regardless of how much integrity and reliability can be placed upon the management, since it is a human trait not to admit the possibility of a loss.

In conclusion, therefore, the auditor should scrutinize his problem over and over from all possible angles, and keep in mind three important questions which he should answer satisfactorily:

1. What is the possibility of existing fraud?
2. How much reliance can be placed upon the book record?
3. What misunderstandings, warranties, and conditions exist which may bear upon the matter?

The possible complications are many since not only may actual cash and other property be involved, but there may exist accounts in respect of personal services, in respect of the exchange of assets between organizations — as where the members of one organization have connections with some other organization, etc. — all of which are considered in error as accounts receivable.

Valuing Accounts Receivable: Bad and Doubtful Debts. — In attempting to ascertain from the evidence available — as suggested above — whether any balances represent debts not recoverable, or debts of a doubtful nature against which reserves should be made, the following points should be observed when examining balances:

1. Term of credit allowed
2. Age of the debt
3. Whether account settled regularly within credit term, and advantage of discount taken
4. Whether payments are being made on account and, if so, whether balance is increasing
5. Whether an old balance is being carried forward to be paid off in installments, new goods being sold on a cash basis
6. If payment was made by note, whether same was retired or dishonored
7. Whether any checks have been dishonored
8. What notes exist in the margins covering payment suspension, arrangements with collectors, etc.

If the balances are numerous, a schedule of bad and doubtful debts may be prepared by the office for presentation to the auditor. This should be certified by some responsible official. If not prepared for the auditor, all accounts that the latter considers should be reserved against should be marked on the schedule of balances so that they may be taken up in detail later with the proper officer.

No hard and fast rules can be laid down as to the value of book debts. Credit terms vary not only as between businesses but they may differ, also, in the same undertaking for different classes of goods; further, in certain instances, the credit terms in force may not be followed strictly, or special terms may be granted to particular customers. Therefore, each case ought to be decided upon its own merits. Where accounts are settled regularly, but far after the expiration of the regular credit period, no reason seems to exist for considering the debt as of a questionable nature. Debts, however, which have been barred by Statute, even though considered as good, should be reserved against fully since no legal ground exists for recovery.

If payments have been made on account, and the account bal-

ance continues to increase, the circumstances of the case should be inquired into; should the amount of the debt be found to be within the limits of credit as reported by a credit agency, and such report is recent, no question of doubt need remain. If an old balance is being paid by installments, whereas new goods are being paid for in cash, a sign of weakness is in evidence; the old balance should be considered as doubtful and be reserved against. The point here is that such an arrangement with one concern undoubtedly indicates a similar one on the part of the debtor with others; hence, default in an installment to any one creditor may cause such debtor's insolvency.

Dishonored notes are a sign of weakness. Returned checks may or may not earmark an account as doubtful. If caused by errors in indorsement or in writing the check, the element of doubt does not seem to exist. But if actually dishonored, the account should be considered as doubtful; particularly would this be true if, in the original instance, the check was post-dated.

Accounts out in the hands of attorneys for collection are not all necessarily bad or doubtful. Some persons pride themselves on never paying until sued, and such accounts may be entirely good. But if a considerable period has elapsed since the account was sent out for collection, and no payment has been received, it seems entirely safe to assume the account to be of doubtful nature. All costs incurred are chargeable to the respective debtors' accounts.

Debts should not be written off until no further hope of recovery exists since, if done, the chance arises that the account will be overlooked, with the result that any opportunity of a later recovery is lost forever. Again, to do so offers the cashier an opportunity to appropriate whatever sum may be paid eventually since no charge appears in the Ledger to cover. For these reasons, the use of a Suspense Ledger seems advisable, to which each doubtful account is transferred as soon as that condition arises. In this manner, a check is secured against the bad debts, and the final loss thereon ascertained. Further, no bad debts should be written off without the written approval of some responsible officer; this prevents concealing misappropriations by creating fictitious bad accounts.

The amount of the reserve to be created against accounts bad

and doubtful not written off should represent the full amount of those regarded actually as bad, whereas the doubtful items should be reserved against according to their estimated value, the loss estimate being liberal. A general working rule, subject to exceptions, considers accounts as bad when one year old. Further, special cases should receive special treatment. Where the debts are numerous and of an average amount, the reserve may be calculated as a percentage on:

1. The outstanding accounts
2. The average accounts
3. Sales

preference probably being in favor of the first method of determination. Where the accounts have been aged by months, the determined percentage should be checked against the list of overdue items as a further guard against the accuracy of the result reached. Some guide as to adequacy may be secured by determining the normal credit loss of previous periods.

Frequently, the provision for losses on accounts receivable is calculated as a percentage of monthly sales. If so, the valuation reserve account is on the books at the time the audit is commenced. This should be scrutinized closely and be verified by the auditor at the time he analyzes and ages the accounts receivable.

After careful investigation, if the auditor believes the reserve as carried is insufficient, strenuous effort should be made to have the additional amount taken up which he deems necessary. If the client refuses to permit this, the auditor should cover the situation in his report stating to what extent the reserve appears to be inadequate. Such inadequacy is of material importance since it affects directly the correctness of the Balance Sheet and the Profit and Loss Statement.

Sales Discounts; Returns and Allowances. — Cash discounts, which it is presumed the customers will take when settlements are made, represent a shrinkage in the amount of the collections from the accounts receivable. Theoretically, provision may be made against this collection loss through such shrinkage but, practically, such an adjustment, except in rare instances, never is made. The practice may be indicated as under:

1. Where the terms call for small cash discounts (2/10, etc.), the matter is ignored.
2. In many lines, when bills are paid, a large discount is given, as perhaps 6%. Such a discount is a trade discount, although different in character from the usual trade discount in that it is not a reduction from list price; provision always should be made for a reserve large enough to cover the shrinkage in settlements due to this cause.

It is desirable, frequently, to prepare a schedule of returns and allowances directly off the Customers' Ledger, and to agree the total with the Ledger accounts. Care should be followed to observe whether returns and allowances entered in the forepart of the period beyond that being audited belong to the audited period.

The percentage of returns and allowances, and of discounts, to sales may be calculated by the auditor for comparison with the figures of previous years, to determine that they are of normal amount. These topics have been covered more in detail in previous sections of this chapter.

Accounts Receivable Pledged. — The auditor should satisfy himself that no accounts receivable have been pledged or assigned. Frequently, the title to accounts receivable has been conveyed as collateral to banks, trust companies, and brokers, with the right of collection remaining with the borrower, and no record being made in any public office to permit the public's being placed on guard. Even though circumstances may make the conveyed title defective legally, and valueless, the auditor should realize that all possible information concerning pledged assets is of major importance and a procedure be adopted which will dig up this information.

Various kinds of documents and papers coming under the auditor's scrutiny may give him the desired clue, and be valuable in determining the title of existing assets and in securing the information needed with reference to their being used as security. Too often an auditor is guilty of passing both notes and accounts receivable at book value, if they are comparatively recent, and assuming that everything is in order.

Circularization of Accounts Receivable. — The only satisfactory way for an auditor to satisfy himself that each account receivable

is correct and represents an unpaid *bona fide* claim, and protect himself fully against possible fraud, is to secure an independent check against the account balances by communicating direct with the customers, provided the client grants his permission to do so. This matter ought to be gone into with the client early in the assignment so that the auditor may protect himself should something wrong develop later in connection with the accounts receivable which through no fault of his was not uncovered.

Hereunder, each customer is advised of the balance against him upon the client's Ledger and he is requested to notify the auditor personally if this balance does not agree with the balance shown upon his own Ledger representing the amount owed by him to the client. It is vitally important for the auditor to make certain that the debtors' answers will be sent to him direct; further, the inquiries should be prepared under the auditor's personal supervision, and he should make certain that each inquiry is placed in the mail exactly as prepared. Mail of this kind must be entirely beyond the control of the bookkeeping staff if possible interference is to be avoided.

Theoretically, this circularization should be a part of every audit; but many auditors will not deem such a procedure necessary if a complete system of internal check is in use. Again, direct verification may be considered as impossible owing to the large number of small accounts in existence; when such is the case, direct correspondence with the debtors whose accounts are shown as being past due or in dispute would be in order. However, unless the balances of the accounts receivable are verified by direct communication, the auditor should be careful to qualify his certificate accordingly.

The usual circularization procedure is carried out in a number of ways, the following being illustrative and perhaps the most common:

1. Monthly statements are prepared by the client's office force and then turned over to the auditor to be checked by him, after which the auditor sends them out direct. Care must be exercised to prevent these statements from falling into the hands of the client's staff after being checked. The returned statements should reach the auditor without being opened by a representative of the client:

a. These return statements may be mailed direct to the auditor's office, or

b. The returns may come to the client's office in envelopes which can be identified and which will be presented to the auditor immediately as received without being opened.

Each statement sent out has affixed a rubber stamp notice about as follows:

> Please verify balance above at once
> and return immediately to
> JOHN JONES
> CERTIFIED PUBLIC ACCOUNTANT
> 1111 Temple Building
> Syracuse, New York

2. A special form letter is sent out with each statement, this having a perforated form attached, requesting the customer to verify the indicated balance on this blank form.

Any such verification, however excellent, may be somewhat unsatisfactory in that a large number of customers frequently pay no attention to the request, and probably among these are the accounts concerning which such confirmation is most desirable to secure; hence, a complete verification, under all circumstances, is impossible by this means. The auditor should keep prodding away at the larger balances until the desired verification thereof is secured; it would seem that he ought to receive replies from at least about 80% of all the accounts outstanding in order to satisfy himself that they are in order.

Proving Accounts Receivable through Sales and Cash. — The expedient of proving the accounts receivable through the records of sales and cash is a most valuable one to use; it has been illustrated above in connection with setting out the basic audit formula and represents, in fact, a practical application thereof:

1. Accounts receivable, beginning of the period
2. Add charge sales during the audit period (sales records)

3. Deduct cash received (Cash Book)
   discounts, returns, and allowances (records covering)
4. Accounts receivable, end of audited period

Auditing Accounts Receivable: Federal Reserve Suggestions. — The following is taken from the Federal Reserve Bulletin:

"The bookkeepers of the accounts-receivable ledgers should be asked to draw off lists of the open balances at the end of the fiscal period, and distributions of the total columns should be shown on the lists according to the age of the accounts, *e.g.*, not yet due, less than 30 days past due, more than 30 days past due. The accounts paid since the close of the fiscal period should be noted in the lists before taking up the matter of past-due accounts with the credit department, as payment is the best proof that an account was good at the date of the audit.

"The totals of the lists of outstanding accounts should agree with the controlling account in the general ledger if separate ledgers are kept. When credit balances appear on customers' accounts they should be shown on the balance sheet as a separate item and not deducted from the total of debit balances; and debit balances on the accounts-payable ledgers should be treated in the same manner.

"The lists should be footed and compared in detail with the customers' accounts in the ledgers.

"The composition of outstanding balances should always be examined, as it frequently happens that while a customer may be making regular payments on his account, old items are being carried forward which have been in dispute for a considerable period of time. Such items and accounts which are past due should be taken up with the credit department or some responsible officer, and the correspondence with the customers examined, so that the auditor may form an opinion of the worth of the accounts and satisfy himself that the reserve for bad and doubtful accounts set up by the company is sufficient.

"Trade discounts (and also so-called cash discounts, if exceeding 1 percent) and freights allowed by the company should be inquired into, and if they have been included in the accounts receivable a reserve therefor should be set up in the balance sheet. Also inquiries should be made regarding customers' claims for reductions in prices and for rebates and allowances on account of defective materials, so that it may be seen that a sufficient reserve has been established therefor.

"Inquiry must be made as to whether any of the accounts receivable have been hypothecated or assigned, and the sum total of accounts so listed entered under 20 *b* (see *post*).

"The auditor should satisfy himself that the bad debts written off have been duly authorized by responsible officials.

"Accounts due from directors, officers, and employees must be stated in the balance sheet separately and not included as trade accounts. This

applies also to deposits as security, guarantees, and other extraordinary items connected with sales.

"Accounts due from affiliated concerns must not be included as customers' accounts, even though arising as a result of trading transactions. Affiliated companies' accounts should be shown as a separate item of 'current assets' or as 'other assets,' as the circumstances warrant. They may be fairly included as 'current assets' if the debtor company has ample margin of quick assets over its liabilities, including such accounts.

"Optional. — The best verification of an open balance is a confirmation by the customer; therefore, if time permits and the client does not object, it is advisable to circularize the customers. The auditor should personally see the circulars mailed after comparing them with the lists of outstanding accounts. The envelopes for replies sent with the circulars should be addressed direct to the auditor.

"In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid and not correctly credited on the accounts-receivable ledgers, but in small concerns, with imperfect systems, such occurrences are quite possible, so much so, in fact, that it is generally admitted that the risk of errors and omissions decreases in direct proportion to an increase in bookkeeping."

CHAPTER VIII

AUDIT OF THE ASSET ACCOUNTS (*Continued*)

INVENTORIES

Introduction. — Since the trading transactions related to purchases comprehend the buying of items other than goods, as expenses, etc., it seems undesirable at this point to discuss these matters. Hence, comment is deferred thereon until Chapter XII, in which the audit of the expense accounts is considered.

Where transactions have been recorded correctly, evidence is at hand in the records of all assets acquired in the course of business; however, verifying the correctness of a Balance Sheet as shown by the books, is not sufficient. It is necessary for the auditor to do considerably more — to go further and verify by actual inspection or otherwise the existence of the assets. An entry may appear in the books recording as asset, and the accuracy of such entry may have been vouched; but this merely proves the asset ought to exist, not that it actually does. Again, certain assets may be unearthed which have not as yet found expression in the books of account.

One common form of fraud is the misappropriation of cash or other assets of a readily negotiable character; the precautions to be taken hereunder to prevent the substitution of assets have been commented upon above from time to time. Another form of fraud which asset verification guards against is the improper inflation of values, or the inserting in the books of an asset that either does not exist now or that never did. Undoubtedly, the commonest instance of this is the inflation of stock inventories either by overvaluation or by the inclusion of fictitious items.

Inventories: Components. — An inventory, broadly speaking, is a list of property values, as:

1. Inventory of all the assets of an enterprise or of an estate
2. Inventory of tools

3. Inventory of fixtures
4. Inventory of goods (in hand, in transit, out on memo, out on consignment), supplies, packing material, coal oil, waste, postage, etc.

From a practical accounting point of view, the term "inventory" used without qualification, refers commonly to goods on hand:

1. In a trading enterprise
   a. Goods on hand in a completed state (although not necessarily finished) ready for sale
2. In a manufacturing establishment
   a. Raw material
   b. Manufactured goods
      i. Finished
      ii. Unfinished

It is this common acceptance of the term "inventory" that is considered in the present discussion. An attempt is made to separate the subject matter along the lines indicated in the set-out above. The basis of values, ordinarily, is cost, although the conservative rule is stated "cost or market whichever is lower."

There are two kinds of inventories:

1. Physical. This relates to an actual inspection and count of stock at a given time, as at the end of an operating (fiscal) year. The physical inventory written record shows units, prices, amounts, and total, the number of units for each item having been determined by actual count.
2. Perpetual or book. Practically, this amounts to drawing a Trial Balance of a loose-leaf or card Material and Supplies Ledger, Cost Ledger, and Finished Stock Ledger. It may refer to raw material, to goods in process of manufacture, or to completed goods ready for sale; if used in connection with goods in process, a cost system is found.

Inventory Problem. — Since the correctness of the profits of a business undertaking depends largely upon the accuracy with which the inventory is valued as on the date of the Balance Sheet, the verification of this asset is a most important duty. The

auditor's problem of passing intelligently upon the inventory is one of the most difficult with which he is confronted, since attended by many more difficulties than in the case of other assets inasmuch as, generally, no book entries appear showing what should be in hand. Further, it is a recurring problem since in every audit the inventory must be examined. Beyond a doubt, the accounts dealing with goods are manipulated for one purpose or another as much as, if not far more than, any of the others:

1. Some persons wish to show as much goods on hand as possible in order to present a better financial condition than otherwise might be the case.
2. Others, as those who have charge of storerooms, may wish to shrink the inventory in order to cover personal misappropriations of goods.
3. Others, again, feel that no goods should be taken up on the books until they actually are on hand; either they have no knowledge of law as to when title passes, or they attempt to manipulate with the end in view of having a good looking credit statement. Since current assets should be in the ratio of about 2 to 1, as compared with current liabilities, the omission of goods items from among the assets, as covered by invoices on hand not booked, offset by the omission of a like amount of accounts payable, means that the current assets total decreases about one-half as rapidly as does the current liabilities total. Hence, to secure a 2 to 1 ratio, such omissions may be attempted.

The auditor will do well, concerning any inventory, to adopt a beginning attitude that the reported value is incorrect and inflated and take steps to justify his contention. Particularly would this be true in style goods, and in 90 cases out of 100, it is apt to be true concerning any other kind of goods.

A typical inventory condition is about as follows, regardless of the undertaking:

1. Current moving merchandise means a rapid flow of values in and out.
2. The volume of transactions is large so that current work is done under pressure, every clerk being so busy that one with evil intentions fears practically no interference; hence, manipulations seldom are discovered by those on the inside.

3. Many angles of the inventory problem are not guarded by internal check.
4. If stocks are large, their valuation by insiders never will be conservative, as a general rule; hence, the competency of the valuers is a matter to be carefully inquired into.

Inventory Responsibility. — Practically, an auditor has no legal, but considerable moral, responsibility in respect of inventories. Since only infrequently will he actually superintend the taking of an inventory, but rarely can he certify to the unqualified correctness of the inventory figures; as far as he can go, ordinarily, is to apply certain tests to satisfy himself reasonably that the inventory is correct. He cannot be expected to verify the existence of stock by actual inspection, and it is not his duty to do so except under particular circumstances. He is not an appraiser, and whatever technical knowledge he may have of a particular concern, as a rule, is not sufficient for forming an opinion as to the correct valuation of the stock. Usually, therefore, an auditor cannot verify the existence of this asset by actual inspection or by referring to the books of account, and he cannot make use of methods available for the other assets, as investments. Hence, his verification is performed by passing upon the accuracy of the stock sheets submitted to him.

In general, to discharge his moral responsibility properly and, further, to assure himself that the inventory is reasonably correct, the auditor works along the following lines:

1. He attempts to determine that the inventory sheets represent actual facts — that the units of stock shown in the inventory actually were on hand on the date it was taken.
2. He attempts to eliminate from the inventory:
   a. All damaged or obsolete goods, at least as to leaving them there at other than a nominal value
   b. All fictitious items
   c. All goods held upon consignment
   d. All articles sold and billed but not yet shipped

   As to (1) and (2), it would seem that only gross negligence need be protected against.
3. He attempts to ascertain that the figures used in pricing the inventory were:
   a. Correct
   b. Cost or market, whichever is lower.

   Only reasonable skill and ability as a professional practitioner seem contemplated hereunder.
4. He attempts to assure himself that all goods received from vendors and included in the inventory have had a corresponding liability taken up on the books therefor.
5. He attempts to establish the correctness of:
   a. Extensions } As to detail sheets and summaries pre-
   b. Footings } pared therefrom

   No substantial errors should exist in extensions and footings; even slight negligence hereunder seems reprimandable. Inventory summaries should be entered correctly in the books.

Further, in the discharge of his responsibility in connection with inventories, the following may be of interest:

1. He is not a valuer.
2 It is not his duty to take stock.
3. Where circumstances are not suspicious, he may rely upon representations of responsible officials.
4. He is not guilty of negligence if a certificate is accepted from responsible officials as to inventory values.

The above points are suggested in the English case of Kingston Cotton Mill Company (No. 2, 1896, 1 Ch. 331). It is believed, however, that the above should not represent the only duty of the auditor hereunder; in addition, it would seem that he should satisfy himself by a thorough testing of the inventory (*post*).

Internal Check. — In order to pass upon an inventory intelligently, the auditor must have a good understanding of the particular system used by his client, because it is incumbent upon him to be exceedingly critical in his examination of all transactions not guarded by internal check.

A proper understanding of the system in operation comprehends the following points:

1. Accounting procedures in connection with purchasing and stores
2. How invoices are checked and extended
3. How invoices are protected and revised

4. The routine of the shipping department and the integrity of the methods used therein
5. Whether the invoices and tally sheets have been prepared in regular and due form or whether the procedures in use operate toward irregularity
6. Comprehension of all documents which represent bills of lading

Illustrative Audit Plan: Inventories. — A portion of a representative audit plan covering the item of inventories may appear as under:

INVENTORIES:

a. Count quantities.
b. Scrutinize pricing methods: mistakes in set-out; prices not mixed; cost or lower (market).
c. Test large items.
d. Test-Check extensions.
e. Test-Check footings.
f. Should inventory be reduced in value (depreciation)?
g. Scrutinize opening figures to prove accuracy of Profit and Loss Statement.
h. Compare with General Ledger.
i. Have all items been paid for, or vendor properly credited?
j. Scrutinize purchase invoices.
k. Verify consignments-in by correspondence.
l. Consignments-out carried at cost?
m. Secure certificate as to correctness.
n. Secure certificate as to obsolete goods.
o.
p.

Trading Inventories. — Although ordinarily, no attempt is made to keep a perpetual inventory record of goods on hand, such a one may be found; hence, the comments hereon divide themselves somewhat along these lines:

1. Where no accounting record is kept of merchandise on hand. All purchases are charged at cost to an account, and all sales are credited:
   a. To the same account, or
   b. To a separate account which later is offset against the purchases.

   No effort is made to separate the cost and profit in the sales price. When the books are closed, an actual physical inventory is compiled, called "taking stock," by the client's staff. The Purchases and Sales accounts are gathered into a Trading account, the beginning inventory for the period is charged to this account, and the ending inventory is credited thereto and charged to a new Inventory account. Naturally, therefore, since every dollar in value added to the inventory affects in full amount the profit or loss outcome of the undertaking, the auditor is justified in using certain precautions before accepting the inventory for use in the accounts.
2. When a perpetual inventory record is kept of goods on hand. Hereunder, an effort is made to separate the cost and profit in the selling price. The cost of sales is carried to the credit of the Purchases or Goods account, and the profit is carried to a nominal profit account.

Only rarely is the inventory actually taken under the auditor's supervision, and only infrequently will he check and verify each item thereof. If he is not on hand when the inventory is taken, it might be absolutely impossible for him to check and verify each component thereof; inventory items change continually, and at the time of audit, beyond doubt, will be changed greatly. Hence, it is said that an auditor is responsible only for such general tests as may be made in the scope of a regular audit.

As a matter of protection, the auditor should require a formal certificate from:

1. Some responsible officer or representative under whose direction the inventory was taken, or
2. The person who counted and recorded the inventory (not as good as 1) attesting or certifying to the accuracy and validity of the inventory. Ordinarily, this inventory certificate will be fairly elaborate as to the points covered over the official's signature — certifying to the fact that all articles included in the inventory were on hand on the date in question, that obsolete and damaged goods are not included, that goods sold and billed but not yet shipped are not included, that goods on consignment are not included, etc.

Upon the basis of the inventory summary, the actual original lists or inventory sheets (never copies) should be scanned and inspected, and the following procedures observed:

1. Prove, or test thoroughly, all calculations, extensions, and footings. In this connection, probably only the larger items are tested. If an inventory is at all extensive, it is a practical impossibility to check every item and all extensions. The auditor must ascertain how the extensions have been made; if hand made and not rechecked, the requisite work is considerably greater than if the calculations were made by a machine and checked back by machine. In fact, if Powers or Hollerith tabulating machines are used, the results therefrom usually may be taken as correct, since serious errors seem remote. In testing footings, the auditor may refoot each column, or he may run through each column rapidly and make a rough comparison with the result; the use of an adding machine may consume more time than footing columns mentally.
2. See that each sheet is initialed by the person or persons responsible for it.
3. A clear understanding (preferably in writing) must be had as to just how the inventory was taken, what prices were used, how the prices were arrived at, etc.
4. Prove selected items against bills covering purchases, and test same against published current market prices of such items in trade papers, or against purchase contracts in existence. The auditor must be assured that the prices are correct. Mistakes may be made in setting down the prices:
   a. The price used may be lower than it should have been.
   b. The price used may be higher than it should have been.
   c. Prices may have become mixed.
   Notwithstanding variances in opinion, the best practice beyond doubt specifies that the inventory should be priced at cost unless the market is lower than cost, in which event it should be priced at market; further comment on this point is made in relation to manufacturing inventories (*post*).
5. Inspect inventory carefully to guard against articles obsolete, shop-worn, or unsaleable. Often, such items are carried year after year at cost. The auditor may be protected in this regard by having the inventory certificate cover this point — that the inventory contains no such material — and by making a trip of casual inspection through the place

inquiring into anything that appears to fall under this heading, and exercising keen judgment as to whether or not any importance should be attached to what is discovered.
6. Classes of goods should be compared with the previous inventory to determine that the same basis of taking has been used. Certain items may be selected and their validity tested in view of average consumption and average purchase of such items, as indicated by the records of previous years.
7. Sometimes sales subsequent to inventory time should be scrutinized, determining the margin of profit involved. If the inventory has been padded, the margin of profit for subsequent sales would be considerably smaller; hence, a clue thus may be secured as to manipulation.
8. If the rate of gross profit is fairly stable, as under normal conditions, the gross profit test may be applied to prove the approximate accuracy of the inventory. This test cannot be utilized in every case, but may be found profitable in the majority of them. The test is applied as follows: Deduct from the amount of the opening inventory and the purchases, the approximate cost value of the goods sold determined on the basis of the average gross profit to sales computed for a term of years. In other words, if the gross profit percentage for the period being audited is substantially larger than the previous average, the inventory should be scrutinized even more closely than is usual. This test is used merely as a feeler or guide, since by no means should it be considered as final and as ground for making accusations. A sharp increase in prices, as occurred during the Great War, would make the test worthless.
9. The inventory at the beginning of the period should be examined critically so that the changes which have resulted through the period's operations may be shown correctly. Adjustments due to improper items therein contained may not in whole be applicable to the current period; a portion of the amount involved bears on prior periods and, hence, affects the surplus directly.
10. Merchandise, materials, or supplies received just before inventory taking time must be included in the inventory and the offsetting liability be spread upon the books; all sales applicable to the period audited should be accounted for in determining the inventory balance.

It is seen, therefore, that even where the inventory consists only of merchandise, the auditor's problem is not as simple as one might assume. The above, however, covers the major points made use of in examining this type of inventory (an inventory based entirely upon a physical taking).

Perpetual inventories may represent a much easier task for the auditor than where inventories periodically are taken physically. This is especially true where the written record is verified frequently or where the verification of specific items is made by actual count each time the stock thereof becomes low.

Under such conditions, the verification may simplify itself to the following:

1. Make such tests of the detail records as seems desirable.
2. Check partially or completely the inventory cards against the actual quantities on hand in the bins or on the shelves.

Further, in applying the rule of "cost or market" (whichever is lower), it should be remembered that the detail records themselves should not be adjusted, if adjustments are in order; this would be entirely impractical since goods are charged out at cost in order to determine the real cost. Subsequent to inventory time, such a shrinkage will show up in sales made at reduced prices. A valuation account is set up, as Reserve (or Allowance) for Inventory Fluctuations to offset the controlling account upon the Balance Sheet, the contra charge being to a non-operating expense account. The entry thus made is reversed at the beginning of the new period, disappearing into a Surplus Adjustment account. The effect here merely is to adjust the inventory for Balance Sheet purposes without in any way touching the detail accounts or the Stores Ledger controlling account. In many cases, on certain items the market will be higher than cost, whereas, on others it will be lower. These do not offset each other; hence, all items on which the market is lower than cost should be reserved against.

Purchase discounts need not be considered, except that the auditor is justified in following the client's previous practice relative thereto.

It should be noticed, however, that the attitude of certain

auditors varies radically from the above upon the inventory question:

1. Some are satisfied to secure an inventory certificate of a company officer and then check out only the arithmetical accuracy of the inventory and the prices.
2. Some go a step further than the above and make use of the gross profit test.

However, it would seem that the auditor is decidedly in error if he does not give as careful consideration to the inventory as he does to the cash asset. One is as important as the other, so far as a business undertaking is concerned, and the auditor should make it his business to be shown that the inventory is in order rather than accept someone's word as to its accuracy, even though such word is crystallized in the form of the usual inventory certificate. Frequently, the inventory item is the largest current asset encountered.

The tests suggested above, though not of themselves proving the correctness of the stock, should protect the auditor against any negligence charge should errors or fraud be encountered later, provided the application has been sufficient. If satisfied that the stock is correct, no reference thereto need be made in the Audit Report; but if either the nature of the business or the manner in which stock was taken is such that satisfaction is not evident, the report should contain some protective reference, as the facts seem to justify.

Proving Trading Inventories in Total. — Sometimes, it may be desirable to secure a check figure upon the ending inventory as an indicator against which the auditor may work. This is illustrated by the following:

1. The usual audit formula may be stated as follows: Beginning inventory plus purchases, minus cost of merchandise sold or used and approved shortages, equals ending inventory.
2. Retail price plan. In certain lines of business, as cigar and candy stores, or in certain sections of department stores, this test may be worth while. Briefly, all beginning and ending inventory values and purchase values are translated into the retail price; then the following formula is applied:

Beginning inventory (at sales price) plus purchases (at sales price), minus sales and adjustments (at sales price), equals ending inventory (at sales price). The ending inventory, having been verified at sales price, it may not be a difficult task to convert it back into cost price for Balance Sheet purposes. However, if merchandise frequently is marked down to move it, as for purposes of special sales, or if sales prices change from time to time, the plan may fail to be of any practical worth.

Manufacturing Inventories: Raw Material or Stores. — The inventory of a manufacturing concern consists of:

1. Raw materials or stores
2. Unfinished product or work in process
3. Finished product or finished goods
4. Scrap

For purposes of discussion, these may be divided on the basis of what constitutes price:

1. Raw materials or stores
2. Work in process and finished goods
3. Scrap

The prices of raw materials must be gone into thoroughly through reference to invoices. Since the price of every item in the inventory cannot be verified, the more important and higher valued articles may be selected and their cost verified by comparison with recent invoices — as invoices covering the last purchase. Usually, those used will be those found on invoices covering the last purchase. However, variations will be noticed, about as follows:

1. An average price may be used — as where goods have been purchased at varying prices, and the stock belonging to any one parcel cannot be distinguished from that belonging to another.
2. Freight and cartage inward may be included in price.
3. Arbitrary prices may be used:
   a. Without regard to judgment.
   b. With regard to the judgment of some person who is intelligent, and who is consistent, careful, and conservative in fixing prices.

The auditor may or may not accept the values as set; if conservative, and if the price setter seems to be consistent, careful, and conservative, he may pass the matter with safety.

The raw material inventory may be tested by practically the same principles mentioned above relative to trading inventories because, if inventories are considered with regard to prices, these two kinds seem to fall under the same grouping.

If the accounting system provides for a perpetual or book record, this latter supplies a basis for the inventory figures. In a manufacturing undertaking, a book inventory is operated in connection with a cost system; in a trading concern, a perpetual inventory is not in the usual order of things. The audit contemplates merely:

1. Test submitted figures against the book records.
2. Determine how often each year the book figures have been tested by physical inventories:
   a. Such test should be made at least twice a year.
   b. The extent of the discovered discrepancies should be known.
   c. The adjustments that have been made in the figures should be determined.

If such tests have not been made, an inventory based entirely upon book records should be accepted cautiously, since experience demonstrates that many marked discrepancies are to be found in every case. Differences constantly are found to exist but regardless of legitimate cause, they should not exceed a certain percentage arrived at through experience. The reason for any material difference should be traced, since if the actual stock is less than the booked amount, the difference may be caused by irregularities. In any event, book figures must be adjusted to actual.

In certain manufacturing establishments where from time to time in the different stages of manufacture the stock becomes exhausted, both at the production point and in the storeroom, the inventory may be checked out quickly and accurately. Each time an exhaustion occurs, the going inventory is corrected, if need be. Hence, in proving the inventories at the end of the period it is necessary only to trace purchases and production

from the date the last exhaustion occurred. Likewise, by the same means, the beginning inventory can be checked out accurately. Some auditors call this a " cut-off " inventory.

Materials and supplies received just prior to inventory-taking time must be included in the inventory and the offsetting liability booked.

Goods in transit must be examined carefully as to:

1. Invoice dates
2. Vendors
3. Description (in detail, as to items, grade, quantities, unit price, etc.)
4. Payments on account
5. Market quotations
6. Etc.

Perhaps at the time of audit, vouchers to cover will have been paid; these should be checked against correspondence, and their dates should be noted as being prior to the close of the audited period. Again, the receiving tickets subsequent to the period's close should be examined to trace the incomings, and the inventory cards should be scrutinized for the same purpose. Expenses, other than invoice cost, related to in transit goods, should be carried separately upon the Balance Sheet.

Existing purchase contracts, when of considerable amounts, or where the market is now down should be commented upon in the working papers, after careful examination. Full particulars thereof should be schedulized. Where partial deliveries have been made, a correspondence confirmation seems in order. Where advances have been made on purchase contracts, their amount seems properly to be included as a separate item under inventories.

Manufacturing Inventories: Work in Process and Finished Goods. — The principle that only the cost of materials, labor, and factory overhead should be considered in valuing the work in process applies with equal force to the inventory of finished goods. Hence, the principles mentioned below seem to require but scant separation in their application to both classes of goods. Nevertheless, unless the junior assistant is under constant supervision, the in-charge accountant should do most of the work hereunder.

The inventory values should contain nothing but actual cost as above suggested — materials, labor, and a proportionate amount of factory overhead. Since the selling and general administrative expenses are not part of the factory overhead, under no condition, in general, should they be included in the inventory values of these two classes of goods. Again, only infrequently will the finished goods inventory be carried at selling prices; if so, the anticipated profit requires elimination.

Basically, the problem confronting the auditor is to determine how these goods have been priced and whether this basis is logical. If a cost system is in use, the auditor's problem is simplified somewhat as he has something definite against which to test prices. However, as a general rule, only where the cost records articulate with the general records can costs be definitely proved as correct.

The goods must be separated as to departments or as to stages of completion in which the goods were found at the time of inventory taking, and the following determined:

1. Material used up to the point where the inventory was taken
2. Labor used up to the point where the inventory was taken
3. Overhead applied stage by stage on a percentage basis

All the goods in the various stages of completion are tabulated by units as of the inventory date, sharp lines being drawn as between such stages of completion; then the material that has entered into the product is calculated for each stage. This contemplates the following:

1. The material cost per unit is determined from either the cost system or from reference to invoices. In the latter event, this determination proceeds about as follows:
   a. A study is made to determine how much material was necessary to make a given number of units.
   b. On the basis of the selected price the cost of this given number of units is ascertained, and the cost per unit.
2. The number of units found in the inventory multiplied by such unit cost produces the material cost for each such stage.

The labor cost for each stage is calculated in a similar manner. If cost records or bills of prices are not available, the labor cost may be determined by running a study similar to the above.

The overhead charge is difficult to criticize; it should be reasonable in any event. It may or may not have been computed scientifically. If an apparent arbitrary percentage is used, the auditor should question the underlying reason therefor as against the use of a different percentage.

The operation of a good cost system simplifies the verification of the inventory of a manufacturing establishment. Records are available in the cost department which should agree closely with the inventories of goods in process and finished goods; further, The Stores Records' balances should agree closely with the physical inventories. This agreement may be determined first by a scrutiny of the controlling accounts for stores, goods in process, and finished goods, before examining the accounts in detail. Hence, a thorough scrutiny of the system of accounting for stores and stock and of the cost system is in order if the auditor expects to pass intelligently upon the validity of the inventory.

After the auditor has become acquainted with the general method of cost determination in use, production orders should be examined and tested. A number of them should be traced through to point of completion to determine how large the adjustments are thereon. Ignorance of this step prevents the auditor from forming an approximately accurate valuation of both the in process and finished stock inventories. In other words, the burden item must be carefully analyzed. Not only must all applicable burden be included and be distributed properly, but it seems desirable to have the applicable burden not contain such elements as interest, selling expenses, and general and administrative expenses.

It would seem that the value taken, in no event, should exceed the price at which similar goods may be purchased in the market; where actual production cost exceeds the market of similar goods valuations may be made at the lower level. Such conditions are encountered frequently when a business is new, or when a plant is not working at normal capacity.

The finished product inventory must be scrutinized carefully

for obsolete items, and for items the value of which is doubtful, in order to be protected against an overstatement of the inventory value thereof.

Stock cards which are inactive should not be passed over lightly.

Again, the beginning inventory should be examined closely so that the changes which have occurred as the result of the period's operations may be shown correctly. If improper items are contained in the beginning inventory, the entire charge-off of such items ought not to be made in the current period inasmuch as a portion applies to prior periods with the result that the Surplus account is affected directly.

All sales applicable to the period audited should be accounted for in determining the inventory balance. This may be done by checking the customers' billings at the close of the period under review against the shipping records. Even if not shipped, such goods must be excluded from the inventory.

Where sales contracts are found calling for the sale of large quantities of goods at a special price, such contract price should be checked against the cost of producing these goods. Naturally, the sales price hereunder (adjusted for cash discounts) should be more than equal to the cost of production. Where losses will result because of this practice, they should be estimated and comment thereon provided for in the Audit Report.

Many of the points referred to in other sections — as prices, footings, extensions, goods in transit, certificates, etc., — should be kept in mind in connection with verifying the finished product.

The inventory problem, where the primary value of raw materials becomes mixed with labor and expense items, is decidedly complex, and even where a perpetual inventory system is in operation, this complexity may not be reduced because of the complicated character of some of the transactions.

Where finished stock has been purchased, the verification follows the lines indicated for examining raw materials. The same would be true of purchased parts.

Proving Manufacturing Inventories in Total. — Sometimes, it may be desirable to secure a check figure upon the ending inventories of raw material, work in process, and finished goods, as an indicator against which the auditor may work. The idea

hereunder is to verify quantities in accordance with a plan which may be considered as a formula. The formula to be used varies as to components depending upon which class of goods is involved, and its accuracy contemplates a correct beginning inventory (and in the case of raw materials, also the establishment of the correctness of the purchases). This formula may be illustrated as follows:

Beginning inventory (by quantities) plus purchases (by quantities), minus sales (by quantities), equals ending inventory (by quantities).

In general, a separate verification for each amount and sale of goods must be made.

The same idea may be applied especially in an undertaking in which production is in accord with a formula, where the auditor is satisfied that the beginning inventory and purchases are in order. The total of each class of product sold is multiplied by the formula for each class and the production proved by means of material requisitions. The formula applicable may be illustrated as follows:

Raw material beginning inventory (by quantities of each class of raw material), *plus* purchases (by quantities of each class of raw material), *minus* sales (by quantities of each class, based on formula) — goods in process at end of period (requisitions for uncompleted production) — finished goods at end of period (materials therein per formula), *equals* raw material ending inventory (by classes).

If the raw material inventory proves, the correctness of the in process and finished goods inventories is established. If the raw material inventory does not prove, something is in error concerning:

1. The inventory of raw material
2. The inventory of goods in process
3. The inventory of finished goods
4. Sales
5. Formula
6. Beginning inventory

Manufacturing Inventories: Scrap. — The inventory of scrap should be separated into its material components so that each amount may be priced at market price thereof. Ordinarily, scrap always is overvalued, and if the quantity is considerable, the auditor should hesitate about accepting the values thereof as handed to him.

Supervising the Taking of an Inventory. — If it falls upon the auditor either to be present when an inventory is taken so as to supervise such, or to suggest plans for taking the inventory, he should be most careful in being thorough. Thoroughness will not result unless first he has gone over the ground and examined the case carefully. If he is to be present, it is necessary for him to arrange his time to suit the client, not himself; in fact, in certain enterprises, the inventory must be taken after regular hours, perhaps at night. In taking an inventory, boxes and cases should be opened and the contents inspected so that the auditor will not be guilty of accepting empty containers as being full; but in this particular, unnecessary work for the client should be avoided. The auditor ought to secure a first-hand voucher for the count from those who actually made it under his direction; further, this first count should be verified by a second one made by persons different from those who made the first one, so as to make collusion impossible. If he takes the inventory himself or supervises the taking, the auditor can feel fairly safe in granting an unqualified certificate, since the risks he takes are few, if any.

If the auditor takes the inventory, he can prove the following satisfactorily:

1. Ending inventory
2. Beginning inventory
3. Sales
4. Production

$\left.\begin{array}{l}\text{3. Sales}\\ \text{4. Production}\end{array}\right\}$ Prove through (1) and (2)

In this connection, the following formulæ are available:

Raw Material Beginning Inventory (Quantities) Trader or Manufacturer.

Inventory at end of period (actual by classes) *plus* sales in-process or finished goods inventory during period (by classes), *minus* purchases during period (by classes), *equals* inventory at beginning of period.

In Process Beginning Inventory (Amounts) Manufacturer

Inventory at end of period (actual) *plus* cost of goods completed during period, *minus* total production costs during period, *equals* inventory at beginning of period.

Finished Goods Beginning Inventory (Quantities) Manufacturer

Inventory at end of period (actual by classes) *plus* sales during period (by classes), *minus* finished goods produced during period, *equals* inventory at beginning of period.

Production During Period (Amounts)

Sales of finished goods during period (cost) *plus* inventory at end of period, *minus* inventory at beginning of period, *equals* production during period.

Sales During Period (Amount)

Production during year, *plus* inventory finished goods beginning of period, *minus* inventory finished goods end of period, *equals* sales during period.

Ordinarily, however, the auditor has nothing to do with the count or the plan for the inventory, and will have to accept a certificate concerning the count.

Holding and Subsidiary Company Inventories. — Hereunder, one company frequently bills another at regular sales prices, which means that an element of intercompany profit arises which as yet has not been actually realized. Hence, in consolidated statements, covering the transactions of a group of companies as a whole, all intercompany profit must be eliminated so that the inventories, wherever they happen to be located, may be stated at cost.

Again, hereunder, the inventory problem is complex in its nature.

Auditing the Inventory: Federal Reserve Suggestions. — The following is taken from the Federal Reserve Bulletin:

"Under this caption (inventories) must be included only stocks of goods owned and under control of the owner. Stocks are often hypothecated and if this is the case the fact should be stated on the Balance Sheet.

"Inasmuch as the accuracy of the Profit and Loss account is absolutely dependent upon the accuracy of the inventories of merchandise at the beginning and end of the period under review, this part of the verification should receive special attention. When a Balance Sheet audit is being made for the first time, the inventory at the beginning of the period should receive as much attention as that at the end, and the auditor should take every precaution to satisfy himself that both inventories were taken on the same basis.

"An acceptable program of audit for inventories is as follows:

"(1) Secure the original stock sheets if they are in existence and carefully test the typewritten copies with them and with tickets, cards, or other memoranda that show the original count.

"(2) See that the sheets are certified to or initialed by the persons who took the stock, made the calculations and footings, and fixed the prices, and satisfy yourself that they are dependable and responsible persons. Obtain a clear and detailed statement in writing as to the method followed in taking stock and pricing it; also a certificate from a responsible head as to the accuracy of the inventory as a whole.

"(3) A thorough test of the accuracy of the footings and extensions should be made, especially of all large items.

"(4) The inventories should be compared with the stores ledger, work in progress ledgers and finished product records and stock records as to quantities, prices and values, and any material discrepancy should be thoroughly traced.

"(5) Where stock records are kept and no physical inventory is taken at the time of the audit, ascertain when the last physical inventory was taken and compare it with the book records. If no recent comparison is possible, select a few book items of importance and personally compare with the actual stock on hand.

"(6) Where no stock records are kept, a physical inventory should be taken preferably under the general direction of the auditor. After the inventory is completed, he should apply the same tests to verify its accuracy as if the inventory had been taken before his arrival on the scene.

"(7) When the cost system of a company does not form a part of the financial accounting scheme there is always a chance that orders might be completed and billed, but not taken out of the work in progress records. Especially is this the case when reliance is placed on such records to the extent that a physical inventory is not taken at the end of the period to verify the information shown therein. In these cases the sales for the month preceding the close of the fiscal period should be carefully compared with the orders in progress as shown by the inventory, to see that nothing that has been shipped is included in the inventory in error. Cost systems which are not coördinated with the financial accounts are unreliable and frequently misleading. Special attention should be called to every case in which the cost system is not adequately checked by the results of the financial accounting.

"(8) Ascertain that purchase invoices for all stock included in the inventory have been entered on the books. Look for post dated invoices and give special attention to goods in transit.

"(9) See that nothing is included in the inventory which is not owned but is on consignment from others. If goods consigned to others are included, see that cost prices are placed thereon, less a proper allowance for loss, damage, or expenses of possible subsequent return. This does not include goods at branches, as the valuing of such stocks will be governed by the same principles as apply at the head office.

"(10) Ascertain that nothing is included which has been sold and billed, and is simply awaiting shipment.

"(11) If duties, freight, insurance, and other direct charges have been added, test them to ascertain that no error has been made. Duties and freight are legitimate additions to the cost price of goods, but

no other items should be added except under unusual circumstances.

"(12) As a check against obsolete or damaged stock being carried in the inventory at an excessive valuation, the detailed records for stores, supplies, work in progress, finished products, and purchased stock in trade, should be examined and a list prepared of inactive stock accounts, which should be discussed with the company's officials and satisfactory explanations obtained.

"(13) The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the Balance Sheet. No inventory must be passed which has been marked up to market prices and a profit assumed that is not and may never be realized. If the market is higher than cost, it is permissible to state that fact in a footnote on the Balance Sheet.

"(14) It may be found that inventories are valued at the average prices of raw materials and supplies on hand at the end of the period. In such cases the averages should be compared with the latest invoices in order to verify the fact that they are not in excess of the latest prices, and also with the trade papers, when market prices are used, to see that they are not in excess of market values.

"(15) Make an independent inspection of the inventory sheets to determine whether or not the quantities are reasonable, and whether they accord in particular instances with the average consumption and average purchases over a fixed period. Abnormally large quantities of stock on hand may be the legitimate result of shrewd foresight in buying in a low market, but may, on the other hand, arise from serious errors in stock taking.

"(16) Always attempt to check the totals by the 'gross profit test' and compare the percentage of gross profit shown with that of previous years. In a business where the average gross profit remains fairly constant this test is a dependable one, because, if the rate of gross profit is apparently not maintained and the discrepancy cannot be satisfactorily accounted for by a rise or fall in the cost of production or of the selling price, the difference will usually be due to errors in stock taking.

"(17) In verifying the prices at which the work in progress is included in the inventory, a general examination and test of the cost system in force is the best means of doing the work satisfactorily. In a good cost system little difficulty will be found with the distribution of the raw materials, stores, and payroll, but the distribution of factory overhead cost is one that should receive careful consideration, the main points to be kept in view being:

(a) That no selling expenses, interest charges, or administrative expenses are included in the factory overhead cost.

(b) That the factory overhead cost is distributed over the various departments, shops, and commodities on a fair and equitable basis.

"(18) No profit should be included in the price of finished products or stock-in-trade. The price list should be examined to see that the cost prices of stock are below the selling prices after allowing for trade discounts, and, if they are not, a reserve should be set up on the Balance Sheet for this loss. If the company takes immediate

steps to increase the selling price, however, the amount of this reserve may be limited to the loss on goods which may have been sold since the close of the period to the date of the discovery.

"(19) In the case of companies manufacturing large contracts it is frequently found necessary to make partial shipments thereof. The question then arises as to whether it is permissible to include the profits on these partial shipments in the Profit and Loss account. As a matter of fact, it is evident that the actual cost cannot be known until the order is completed. It may be estimated that a profit will ultimately be made, yet unforeseen conditions, such as strikes, delays in receiving material, etc., may arise to increase the estimated cost. It is better not to include the profits on partial shipments, but information of this character which may have its influence in the decision of the banker upon a proposed loan may properly be laid before him. Of course, an exception should be made in cases where the profit on the partial shipments largely exceeds the selling price of the balance of the order.

"(20) The selling prices for contract work in progress should be ascertained from the contracts, and where it is apparent that there will be a loss on the completed contract a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress.

"(21) If a company has discontinued the manufacture of any of its products during the year, the inventory of such products should be carefully scrutinized and, if unsalable, the amount should be written off.

"(22) The inventory should be scrutinized to see that no machinery or other material that has been charged to plant or property account is included therein.

"(23) Partial deliveries received on account of purchase contracts for material, etc., should be verified by certificates from the contractors, both as to quantities and prices.

"(24) Advance payments on account of purchase contracts for future deliveries should never appear in an inventory, but be shown on the Balance Sheet under a separate heading.

"(25) Trade discounts should be deducted from inventory prices, but it is not customary to deduct cash discounts. However, this may be done when it is the trade practice so to do.

"(26) While the inventory is being verified, the auditor should ascertain the aggregate sales for the last year. If the turnover has not been rapid, it may be due to a poor stock of goods. Some business men dislike to sell below cost and would rather accumulate a big stock of old goods than dispose of the old and unseasonable stock at a sacrifice. The usual outcome is that the stock becomes unwieldy and funds are lacking to purchase new goods. The inventory and gross sales may, therefore, have a direct connection.

"(27) It may be well to reiterate that interest, selling expenses, and administrative expenses form no part of the cost of production, and therefore should not be included in the inventory in any shape."

CHAPTER IX

AUDIT OF THE ASSET ACCOUNTS (*Continued*)
LAND; BUILDINGS

Fixed Assets. — After completion of the work upon the inventories, each Balance Sheet account remaining upon the Trial Balance should be scrutinized, each in turn being thoroughly analyzed in accordance with the existing circumstances. The first group encountered, upon which work is to be done, undoubtedly is that of the fixed assets.

Fixed assets are to be valued upon the basis of cost and, if any are of a wasting nature, the original cost usually should be written off to revenue by means of depreciation over the period of the estimated working life of such asset. On any interim date, therefore, the fixed assets should appear in the Balance Sheet at cost less depreciation (if any) to date, this representing present value to the particular enterprise as a going concern — value to the business proprietors.

Current market value and break-up are disregarded, inasmuch as these have no effect upon the assets' working lives. Current market value comprehends value realized if sold in the open market; break-up value represents forced realization worth as where the business is closed down. Fixed assets, as contemplated by an auditor, should be considered from the viewpoint of their value to the business' proprietor — upon their ability to earn profits.

In view of the above, such Balance Sheet values are somewhat hypothetical; inasmuch as the working life period of a fixed asset cannot be calculated with absolute accuracy, the possibility of error exists in determining asset values. Should errors occur, the profit or loss is affected at once. On the other hand, fluctuations in market value do not affect the proprietor except at the end of an asset's life; then, upon replacement, the cost of the new asset may be more or less than the cost of the original.

Aside from this possibility, market fluctuations are immaterial since they will not increase or decrease the length of the period during which such assets will earn profits; provided the original cost (less scrap) is written off during such period, the results shown by the accounts have been, practically, correct. Under a forced realization, undoubtedly heavy losses would be suffered, but it is not reasonable to anticipate them before calculating current profits.

The various fixed assets of land, buildings, machinery, equipment, furniture and fixtures, etc., should be examined carefully, and detailed schedules prepared therefrom so that the components of each may be kept clearly in mind as the work proceeds. Further, it seems necessary to bear in mind continually the fundamental distinctions underlying the apportionment of expenditures between capital and revenue.

Whatever analyses are made of the cost of properties, and regardless of what may be the accounts used to cover, the working schedules prepared should enable the auditor in charge, and his office, to grasp the entire situation quickly — as to opening balances, additions, deductions, and ending balances; the latter, naturally, should agree with the amount or amounts to appear in the adjusted Balance Sheet. In some instances, considerable detail work is necessary to secure the desired facts; in other cases, the detail may be only a minimum amount.

In general, regardless of whether a Balance Sheet or detailed audit is contemplated, it seems that the auditor, in the present instance, is confronted with the same problem. Not being an appraiser, an operative acting in his capacity as auditor must proceed more or less indirectly in his verification. His work in this connection may be summarized as under:

1. Account analyses
2. Exclusion or elimination of expenses which have been capitalized in error
3. Careful scrutiny of the character of all credits to these accounts
4. Determination of the reasonableness of the balance in each account
5. Inspection of the assets themselves

6. Determining who actually possesses title to the assets in question
7. The hypothecations or pledges existing against properties

The end in view is to determine the facts of the case. If the books are found not to reflect facts, it is the auditor's problem to locate the particulars in which they are in error.

In the verification of properties, the procedure under a first audit and under a recurring assignment cannot well be the same. In the first instance, a too complete analysis of property costs seems impossible, yet whatever is done should be consistent with the fee involved. In a first audit, it is desirable to secure an analysis from the very beginning, unless a cut-off place somewhere in the past has been agreed upon as the point from which to start.

Again, in a first audit, a general certificate is desirable from someone in authority, or from the concern's attorney, stating that property titles are in order and that encumbrances do not exist. The securement of such a certificate, however, does not necessarily seem to permit the auditor to eliminate entirely his investigations along these lines. Also, when possible, some sort of chart or schedule should be obtained showing the location, size, and components of property units. The accuracy of the properties analyses thus prepared may be checked to some extent by an analysis of the Surplus account for the same period (where the latter account exists).

Account Analyses. — A considerable portion of the audit work revolving around the verification and examination of the Balance Sheet accounts, particularly as concerns the fixed items, is done by junior assistants. In connection herewith, the instructions given by the in-charge senior should be full and definite; the senior should encourage the assistants to seek advice from him, rather than take anything for granted. Regardless of how much theoretical knowledge a junior may possess, many matters encountered cannot be solved except through experience.

Inasmuch as the senior is directly responsible for the work done on a given case, he should stand ready to make decisions whenever necessary, and he should emphasize the fact that in any case of doubt he must be consulted.

Land. — Undoubtedly, of the fixed asset accounts, that of Land or of Land and Buildings, or of Real Estate will receive

first attention. If the account holds both land and building values, an analysis thereof must be made to determine (in addition to the usual purposes later encountered):

1. How much of the account represents land and how much buildings:
   a. For passing upon the adequacy of the insurance carried
   b. For calculating or checking the depreciation

In the summary discussion below, the Land item is handled separately from that of Buildings.

Ordinarily, transactions relating to land are traced back to their inception. Particularly is this true in a first audit; in subsequent audits, whether Balance Sheet or detailed, assuming that each such covers a specified period of time, the opening balance for the period may be accepted as it stands, and the then examination made to cover only the additions and deductions during the period under scrutiny.

The audit of the Land account involves the examination of such papers and documents as:

1. Purchase contracts and canceled checks covering payments
2. Land deeds
3. Abstract of title, since many titles are found to be clouded
4. Court records (as those of the County Clerk) to ascertain that titles are clear and no liens thereagainst recorded
5. Tax receipts. These may be asked for at the time the request is made to examine the property deeds and title insurance policies

Notations should be made upon the working papers covering account analysis that the property deeds, abstracts of title, and tax receipts have been seen.

Insofar as title is concerned, that of land is not separate from that relating to improvements and structures thereon; hence, title must be verified as one item. An examination of title deeds is made in verifying ownership; it is important to note that such deeds are executed legally and recorded properly. Deeds in themselves do not necessarily prove ownership, since transfers may have been made subsequent thereto. Further, real estate mortgages may be in existence without any record thereof

appearing in the books of account; naturally, such existence materially affects the interest in the property. In a corporate audit, the Minute Book should show resolutions authorizing the mortgage and the debt secured thereunder; this assumes that the Minute Book has been properly kept.

Real estate ownership in all cases cannot be safely certified to until after the official records thereof have been examined; preferably, in this connection, an abstract of title should be secured and be examined; if such abstract is not in existence, or if the client refuses to secure it, notation thereof should be made for inclusion in the report. Where land is used for plant purposes, and no circumstance arises to create suspicion on the part of the auditor, the absence of an abstract would seem usually insufficient ground for not granting an unqualified certificate; on the other hand, if the real estate units are numerous, some real title evidence should be insisted upon.

Land may be classed under two or three headings as desired:

1. Productive — held for production of income
2. Non-productive — held for sale or other purposes

or

1. Operation
2. Expansion — reserved for future operations
3. Investment (only)

Such a separation is essential in order to distribute accurately the expenses and income of each class.

The original cost price plus legal and recording fees, surveying costs, etc., ought to represent the opening value for Land on the books. If the purchase price seems at all reasonable, the amount need not be questioned. With the point of commencement established, further scrutiny and analysis may proceed.

An analysis of the Land account is necessary to determine that the charges thereto cover only improvements — as filling in, grading, laying out streets, curbing, gutters, laying sidewalks, setting out trees — or represent that which will increase income therefrom, undertaken or completed during the period. As to such improvements, schedules should be prepared in support thereof. Just what schedules are necessary and just what should

be their form depends upon the particular assignment in hand. All such expenditures should be compared with the authorizations made therefor.

The figures at the beginning of the period will come from the auditor's papers of the previous examination if such was made; if not, as in a first audit, they must come from the Ledger accounts and be traced back to inception. Whatever balance is secured as representing the item as of the end of the audit period should be agreed with the Ledger and be reflected in the Balance Sheet.

Capitalized taxes are of frequent contact, and one should distinguish carefully between taxes and assessments. Ordinary taxes (as yearly) represent carrying charges; hence, as a general proposition, they should not be capitalized so as to appear in the Land account. One exception hereto might occur where land was acquired and the construction of a building thereon immediately commenced; hereunder, it may be assumed that the building is necessary before income can be produced and, therefore, the tax upon the land during the construction period, by some auditors, will be capitalized. Special assessments covering paving, sewer construction, water systems, etc., alongside a parcel of land represent land improvements, since they increase land values; these may be capitalized and properly appear in the Land account.

Credits to a Land account ordinarily represent land sold. It should be determined whether each credit representing a sale has been entered on the basis of cost or of sales price; frequently, the sales price is credited thereto (or to Land and Buildings account). If the sales price is credited to the account, two things happen:

1. The profit is not set out, and
2. The profit reduces the book value of the asset.

By determining the cost per square foot or acre, knowing how much land originally was purchased, and ascertaining the number of square feet or acres therein, the amount to be credited to the Land account may be secured readily. Any excess amount remaining should be credited to a separate account — Profit and Loss or Surplus.

Land values, in the majority of cases, appreciate rather than depreciate (as by the passage of time or by use), although in-

frequently depreciation may be encountered. Even though an auditor is not an appraiser, he should watch for possible value inflations, the same as is necessary in connection with any other asset. Inflation of values may not be due to an attempt to perpetrate a fraud, but fraud in connection therewith seems to be of frequent occurrence.

Reappraisal of land values booked should not be approved since profit is thereby anticipated prior to sale; such increase, however, may be passed where offset by a reserve of an equal amount. The inclusion in the accounts of profits on land well may be deferred until the moment of actual realization.

The infrequent contact of auditors with depreciating land values seems of sufficient import at least to warn against the blind assumption that land never depreciates. At times a serious error may be countenanced where such depreciation is not recognized in some way; for example, location may cause land to lose value to its owner to such an extent that a loss must be suffered in disposing of it. On the whole, however, land proper should be carried at cost if purchased and held for the permanent use of the enterprise. Hereunder, an increase or decrease in value has no effect upon the operations of the undertaking. A probable decrease, or increase, a sale not being contemplated, only affects the concern's credit. When a bank extends credit, it may look somewhat at the realizable value of assets securing this credit; hence, the nearer true value is shown, the better for credit purposes. An idea of realizable values may be indicated upon a Balance Sheet without manipulating the assets (although not commonly done). In this connection it may be more to the point to present a Statement of Affairs rather than a regular Balance Sheet.

Land Companies. — Land company Land accounts are subject to excruciatingly careful analysis. Hereunder, only actual improvements should be capitalized. Expenses entailed at the commencement of operations, regardless of kind, never should be considered as chargeable to the Land account; however, they may be carried as deferred items until sales commence. The original purchase is chargeable to an Unimproved Real Estate account; as lots are laid out, Unimproved Real Estate may be credited proportionately at cost to a Lot account in a separate

Ledger. As lots are improved, as by erecting buildings thereon, etc., the cost of each fully improved lot is credited from the Lot Ledger into the Improved Properties Ledger.

All amounts in these Ledgers should be at cost and should consist of actualities, because upon the facts herein depend the entries to be made in the Cost and Sales accounts. Lots remaining unsold at the end of a period should be compared with the maps on hand. Unpaid customers' balances for lots sold them should be verified by correspondence; balances unpaid on tracts purchased should be verified in a similar manner. All contracts covering both purchase of tracts and sales of lots should be scrutinized most carefully. Frequently, payments made on purchase price are prorated against sales receipts. The valuation of land at market prices is exceedingly doubtful of justification because, although all values are based upon opinion, the variety of opinion concerning land values is much greater than that concerning the values of other business assets.

Buildings. — The Building account, on the whole, is audited in a manner similar to that used in connection with the Land account. Basically, the Building account should be analyzed along the same lines as was the Land account, the same classification of the items thereof being in order. Non-productive properties — those used for other than business purposes, or not used at all — represent capital tied up in non-productive assets; such capital should bear a logical relation to production or volume of business so that the unkeep, depreciation, and carrying charges will be at a minimum. If this principle is not recognized, the company earnings cannot reach the amount they should equal regardless of production.

Further, sub-groupings of buildings may be made in order to expedite the application of depreciation rates thereto.

If the concern owns a large number of buildings, a subsidiary Ledger may be in existence holding the detail of a controlling account found on the General Ledger. If this be true, the auditor must make certain that the detail agrees with the control.

An audit of the Buildings account comprehends covering the following points, schedules being prepared thereon:

1. *a.* In the case of a first audit, — original cost or purchase price:
   i. Where constructed — proper vouchers to support entries may consist of architect's certificate and builder's contract, vouchers, or cost sheets.
   ii. Where purchased — proper vouchers to support entries may consist of purchase contract and deed plus receipts for money paid and canceled checks.

   b. In the case of subsequent audits — balance at period's beginning supported by proper documents as indicated above.
2. Additions — These either may be constructed or purchased.
3. Total values at cost
4. Depreciation amounts thus far and rates thereof
5. Values on which depreciation calculated
6. Depreciated values

Credits to the Building account undoubtedly cover items as under (if present at all):

1. Sales of portions of buildings; and probably
2. Depreciation (no Reserve or Allowance for Depreciation account)

All additions during the period must be examined and all expenditures made should be properly authorized. Additions should be booked at cost, but care must be observed to determine that a so-called addition actually is one; the inspection of vouchers and of other original data should bring to light the fact that labor, supplies, etc., chargeable to operation have not been capitalized by having been charged to the property accounts. In other words, debits to a Buildings account must represent real additions or charges which will increase earning capacity; replacements or repairs are not chargeable against the Property account. Repairs, generally, are chargeable to the Reserve (Allowance) for Depreciation account. Replacements, ordinarily, are found to be handled in either of two ways:

1. The asset account is credited (and proper adjustment made in the Reserve for Depreciation account) for the amount of the replaced asset, and the replacement is charged to the Building account.

2. No adjustment is encountered covering the discarded asset, and replacements are debited against the Reserve for Depreciation.

Under either plan, the auditor must govern his procedure accordingly.

In corporations particularly, additions and improvements frequently are approved formally by the directors, and even at times by the stockholders; ordinarily, hereunder, under all circumstances definite instructions or orders covering additions and improvements will have been issued by the managing executive of the company. In connection herewith, the auditor should determine that such authority has not in any way been exceeded.

Construction expenditures may be based upon appropriations which have been voted either by the Board of Directors or by some official committee; in fact, if contemplated construction assumes considerable proportions, this should be the practice. Hence, where such appropriations exist, they must not be overlooked if an acceptable verification of the property accounts is to be made.

These various authorizations which happen to cover expenditures actually made during the period being examined should be scheduled carefully to show such information as number of authorization and construction order, work done, accounts involved, official O.K., amount authorized, amount expended to date, portion of work yet incomplete, estimated cost of completion, over- or under-run as estimated based upon authorization. Every probable overrun should be explained satisfactorily.

If building construction is carried on by contractors, the contracts should be examined, or most of them, and notations briefly made for inclusion among the working papers. Construction under way, or payments made against any such contracts represent part of the total property cost on the Balance Sheet rather than a portion of the inventories on hand.

Frequently, in connection with additions and improvements, contracts are discovered which are as yet uncompleted or upon which some liability still remains attached. These are not to be overlooked, but should be noted in the working papers for report inclusion. Upon the Balance Sheet they should be shown either

as contingent or actual liabilities as the case warrants. For example, if of a substantial amount, the contingent liability for construction uncompleted may be indicated as a footnote to the Balance Sheet; on the other hand, where accruals exist not as yet due and payable, or where installment payments are in arrears, an actual liability exists for inclusion in the Balance Sheet. In the latter connection, verification is secured from a scrutiny of contracts, certificates of work completed, or invoices on hand.

If construction is done by plant employees, an analysis of the material requisitions and payrolls is in order. Work done by plant employees should be booked at cost, no profit therein being recognized. This portion of the examination calls for the preparation of an "analysis of property additions schedule" to be prepared in conjunction with the verification of each property account shown in the Trial Balance. Under certain conditions, as where a part of the regular labor force was withdrawn from their usual duties to aid in construction, a portion of factory overhead may be included as part of the cost of an addition; but where employees work on construction at odd times only, it seems more conservative to exclude a portion of factory overhead as part of construction cost. At any rate, ordinarily, only direct overhead should be included therein. (But see Federal Reserve suggestions on Cost of Fixed Properties, *post* in Chapter X.)

What has been said relative to construction in the present connection seems to be of equal importance in relation to sundry properties commented upon in the next chapter.

The depreciation problem concerning buildings should be given serious thought, to determine:

1. Sufficiency
2. Method of calculation and entry. Depreciation is an operating expense rather than an appropriation of profits.

Depreciation rates should be adequate, being based upon the estimated life of a building plus probable obsolescence. Numerous tables of rates are available related to different types of buildings. The depreciation policy should be consistent, and the Reserve (or Allowance) for Depreciation account should be used. Under certain circumstances, it may prove desirable to use a reserve account in connection with obsolescence.

As has been intimated previously, depreciation is based best upon either engineering estimates or estimates made by those skilled in appraisal work. Inasmuch as the auditor is not an appraiser, at least in his capacity as auditor, he is charged with no more responsibility hereunder than determining in a general way that the depreciation to date is reasonable; hence, if the person upon whose judgment the depreciation is established has a reputation along such lines, such fact should be given considerable weight.

In connection with replacements, briefly commented upon above, the question of depreciation adjustments on discarded assets must not be overlooked. Inasmuch as an undertaking's depreciation schedule or program amounts only to an estimate shrewdly or crudely planned, the auditor will find it necessary, as a rule, to make some adjustment covering the difference between the net book value of the asset and its scrap value as of the moment of discard.

Buildings erected upon leased premises make necessary the writing off of the entire building value during the lease period unless some contract exists under which the lessor partially will compensate the concern. The lease period is the term during which to write off building value, rather than the term expressive of the building's life.

All insurance policies covering buildings should be studied:

1. To determine adequacy of amount carried
2. To determine that the policies are carried in the name of the concern
3. To secure extra proof that properties have not been hypothecated

Different kinds of insurance policies are in force. In the majority of cases it is probable that the policies found will be those containing the 80% clause. Hereunder, it should be remembered that unless property is insured for 80% of its value, the policy holder becomes a co-insurer to the extent of the difference between 80% of the value and the amount for which the property is insured. Frequently, it is found that property owners are ignorant of insurance matters relative to the kinds of policies they hold.

CHAPTER X

AUDIT OF THE ASSET ACCOUNTS (*Continued*) SUNDRY PROPERTIES; INTANGIBLES; DEFERRED CHARGES

Other Properties. — Inasmuch as the other property accounts are similar in their nature to those of Land and Buildings and, in general, may be audited along the same lines as these latter, it seems unnecessary to present a detailed consideration of each of them. The procedures laid down for auditing the Land and Buildings accounts should be sufficient to indicate the basic manner of developing the examination.

The Machinery and Equipment accounts require careful scrutiny and analysis inasmuch as a great variance exists between different plants in the life of the same type of machine. Factory conditions relative to machinery use, time used, expenditures for repairs and replacements of parts must be pondered over considerably before correct conclusions can be reached relative to the Machinery account.

Considerable audit assistance is secured in obtaining a check against the General Ledger account (control) by examining the detail records on hand covering machinery cost, purchase date, number assigned for factory location, type, maker, and description. Usually such records are not in agreement with the General Ledger account, no attempt being made to have them so. A subsidiary Ledger for machinery and equipment should be strenuously advocated, and these records should be placed into agreement with the General Ledger account.

In a first audit, at least, the examination of the Machinery account, due to a lack of detail machinery records, may be of considerable proportions; yet, no slighting of the work should be done because of such fact.

The matter of verifying machinery depreciation presents a fairly elaborate problem. Considerable assistance is secured by using the detail machinery information indicated above. For

depreciation purposes, the machinery may be divided into groups, inasmuch as the same rate cannot in reason be applied to both high-speed machines (with short life) and slow-moving machines (with long life). In fact, some advocate treating each machine as a separate unit for depreciation purposes; hereunder, the adequacy of the depreciation reserve should be determined by the total of the accrued depreciation on all of the machines, each one taken separately.

The depreciation problem should be gone into fully with the management particularly to determine whether they have acted upon correct advice. If the question has been faced properly, if correct principles have been acted upon, and if provision therefor in the accounts seems reasonable and sufficient — the auditor ought to be satisfied; it is not his duty to estimate or value the working life of plant assets. Where depreciation provisions are haphazard, and where the auditor is not satisfied as to the sufficiency, he should clearly point this out in his report.

The Machinery and Equipment accounts should include no obsolete machines. If small tools, subject to loss or destruction, are included hereunder on the books, it is necessary to check their book value against the physical inventory on hand, to permit the requisite adjustments to be made.

Small tools and loose equipment not specifically accorded any definite location are subject to heavy depreciation. Where the amount of these items on hand remains fairly stable, it may prove adequate to establish a normal inventory value therefor which approximates the total investment therein, and absorb through expense accounts all current additions and replacements. On the whole, a revaluation each year seems entirely satisfactory. Hereunder, certified valuations are examined, being tested and checked as far as is possible. Special tools for a particular customer's order generally are chargeable against the customer although he may never be given them; at any rate, they ought not to be found in the factory inventory.

Patterns, drawings, flasks, etc., must be heavily depreciated, inasmuch as their character is such that a gross overestimate of their worth is commonly encountered. Since designs change frequently, and since such assets as these are valueless the moment the design change occurs, the carrying of these assets at a low

figure, often arbitrarily set, seems to be the only means under which a fair setout thereof upon the Balance Sheet may be secured.

The account of Horses, Wagons, and Autos, or accounts similar thereto, requires analysis. Naturally, their components must be set out carefully, at least so that the amount of each on hand may be determined. If possible, a separation by units is in order so that these may be compared with the actual assets on hand. Purchase dates are necessary as a matter of working sheet record so that the depreciation may be checked or calculated. Horses used in heavy service depreciate rapidly, probably about 25% of cost yearly; it may be better to revalue each year. Inasmuch as wagons are being replaced rapidly by automobiles, normal depreciation thereon (10–15%) may be insufficient. Automobiles depreciate rapidly measured by use. For certain delivery purposes, a rate from 15–20% may be sufficient; for heavy delivery use, a rate may be insufficient if under 20–30%. On the whole, experience hereunder seems the best safety valve; in general, a useful life of from two to five years seems reasonable for automobiles. Another method of calculating auto depreciation is based upon mileage consumed as against mileage life as estimated.

The audit of the Furniture and Fixtures account undoubtedly causes considerable trouble; in general, one may say that its examination will prove unsatisfactory at best. The reasons in part for this state of affairs roughly may be shown as under:

1. The particular units, on the whole, are difficult to identify inasmuch as so many different kinds of items usually are included. A Furniture and Fixtures Ledger is of rare contact.
2. It is difficult to distinguish between units which are inexpensive and those which are expensive.
3. The residual value is problematical; generally, it will be small.

The whole matter hereunder seems to resolve itself into having the auditor exercise the best judgment possible, to be wary of passing unnoticed the many abuses to which the account may be subject, and to be ultra-conservative in determining the adequacy

of the depreciation thereon. Tests may be made to determine that the account balance is not increasing disproportionately to the increase in the volume of business.

Depreciation applied scientifically to the Furniture and Fixtures account is a rarity; at best, the amount thereof is a pure guess. Some concerns may book their furniture and fixtures in a memoriter account at a nominal value — as one dollar; although this is a conservative practice, it seems permissible under all circumstances to carry this asset at least at its residual value. Even though depreciation is not calculated scientifically, its amount should be adequate so that the account balance represents to a fair degree the value of the units in hand. Expensive fixtures, as tabulating machines, etc., may require the establishment of a reserve for obsolescence; yet even here, if the depreciation provided is liberal, no criticism ought to be encountered. Wooden furniture, in general, well may be written off within a period of five years, whereas steel furniture may be given an estimated life considerably longer. Should appraisal figures be available as of a past date, a subsidiary Ledger so called may be constructed upon analysis paper by transferring these amounts thereto and then by using the columns at the right for carrying forward from year to year (or period to period) the adjusted value of each such asset item.

Scrapped Properties. — When particular property items have been disposed of in some manner during the audited period, the auditor should prepare some kind of a schedule to cover the entire situation as developed. As to each such unit of property, the auditor should determine the acquisition date, purchase price or cost thereof, what elimination entries have been made upon the books (if any), and what amount of depreciation has been absorbed up to the moment of disposition. The depreciation to the date of the disposal should be taken up correctly on the books.

The loss or profit involved may be treated in any one of four possible ways depending upon the ideas of the particular auditor and the concern's practice in relation thereto:

1. Adjust through Profit and Loss
2. Adjust through Surplus
3. Adjust through Reserve for Depreciation
4. Adjust through Depreciation account

In conclusion, hereunder, all reasonable means should be used by the auditor to determine that fixed assets have not been disposed of without some record thereof being in evidence, inasmuch as if such practice is followed, a net worth overstatement occurs. All such practices which have occurred during the period under scrutiny should be explained satisfactorily.

Cost of Fixed Property: Federal Reserve Suggestions. — Relative to the cost of fixed property, the Federal Reserve Bulletin offers the following:

"In preparing the leading schedules for the accounts grouped under this heading, such as real estate, buildings, plant, machinery, etc., the balances at the beginning of the period, the additions to or deductions from the accounts during the year, and the balances at the end of the period must be shown.

"The total of the balances at the beginning of the period must agree with the cost of property figures given in the Balance Sheet at that date, and the balances at the end of the period with the amount shown in the Balance Sheet that is being audited. The charges entering into the additions must be verified in detail, and in this connection the following notes are of value:

(1) Authorizations for the expenditure made during the year should be examined, and where the costs of the additions have overrun the sums authorized, inquiries should be made in regard thereto. The authorizations should show the accounts to which the expenditures are chargeable, the amounts thereof, the approvals of the comptroller and manager, and description of the jobs. When the authorizations are not specific as to the work done, the actual additions should, if possible, be inspected.

(2) The auditor should satisfy himself before approving additions that they were made with the object of increasing the earning capacity of the plant, and that they are not of the nature of either renewals or improvements, and in this connection changes in the production and in the capacity of the plant should receive consideration.

(3) To verify the payroll and store and supply charges to jobs, one or two payroll distribution reports should be examined in detail, and also one or two storehouse reports. In cases where large purchases have been made from outside parties for capital construction work, the vouchers therefore should be examined and the usual precautions taken to see that they are properly approved for the receipt of materials, prices, etc.

(4) For purchases of real estate the title deeds should be examined, together with the vouchers, and it should be seen that the deeds have been properly recorded.

(5) While it may be considered permissible to make a charge for factory overhead cost to additions to property such as, *e.g.*, time of superintendent and his clerical force employed on construction work, etc., it cannot be deemed conservative business practice, inasmuch as the probabilities are that the overhead charges of a plant will not be decreased to any extent even though additions are not under way, and, therefore, the absorption of part of these charges when additions are in progress, has the effect of reducing the operating costs, as compared with months in which no construction work is under way.

(6) Construction work in progress at the end of the fiscal period should be shown in the Balance Sheet under the heading of fixed assets and not as part of the inventories. This is important to bear in mind because construction work is not an asset that can be quickly turned into money, while everything in the inventory is supposed to be realizable in cash within a reasonably short time.

(7) The auditor should inquire as to whether any installments are due on account of construction work in progress which is being carried on by outside parties; and if so, the liabilities for these installments should be included in the Balance Sheet, as they may have a direct bearing on the amount of available cash on hand.

(8) When a company uses leasehold properties the leases should be examined and notes made of the periods covered, so that it may be seen that improvements, etc., on such properties are written off over the periods covered by the leases.

(9) The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are adequate to reflect the deterioration in the value of the fixed properties. If in his opinion the reserves shown on the Balance Sheet are insufficient, he should call attention to the matter in his certificate.

(10) Care should be taken to insure that property destroyed by fire or otherwise prematurely put out of service is correctly treated in the books. Any portion of the original charge for such property which is not recoverable through insurance, as salvage or otherwise, and has not been provided for by the depreciation scheme should be written off.

It is to be observed that the foregoing notes are to be applied only to cost of properties incurred during the period under audit. In addition, information may usefully be obtained on broader lines in regard to the composition of the real estate, building, and machinery accounts, and showing what principal property is represented thereby and how the accounts have been built up from year to year for a reasonable time past if not from the inception of the business. The information derived therefrom is valuable only in indicating the progressive policy of the concern, the extent to which it reinvests undivided surplus in its plant, etc. Beyond these facts the banker who is asked for ordinary discounts or short-term loans is not interested; he looks more to the quick assets for his security.

"Optional. When the loan is greater than the quick assets seem to justify the auditor should suggest a reliable verification of the cost of property prior to the period under audit. Such action may become necessary even to the extent of calling for an appraisement by disinterested outside experts."

Intangible Assets. — These asset accounts are of no real value except to the concern holding them, and even here such value exists only while the undertaking is a going proposition, or under certain contingencies.

Goodwill frequently is expressive of the difference between the actual value of the physical assets and the purchase price of properties. Under any circumstances the value of Goodwill is difficult to criticize: hence, where fraud is not a factor, it would seem that the auditor will not be subject to criticism if he accepts the basis of valuation agreed upon by the company officers. Further, the auditor may be assisted ably in this connection by finding something thereon in the records, in the Minutes, or in some contract. Basically, any working schedule prepared should show the composition of the original amount, the charges therein, and the balance thereof; the current additions or deductions should be indicated, and the ending balances secured. These latter must be agreed with the Trial Balance.

On the whole, so many theories exist relative to Goodwill that no additional comment seems advisable; if the account has been analyzed and an amount determined therefrom which represents Goodwill, the particular case circumstances govern the decision whether or not its treatment has been logical and conservative.

An account with Patents, Trademarks, and Copyrights may be found separate from the Goodwill account, or all four items may be encountered in one account. Naturally, under either condition the first step is to analyze the account so as to separate the amounts of each. Beyond this, as stated above in connection with Goodwill, the matter of treatment depends upon the theories of the auditor.

Unexpired patent years may constitute the exact basis for writing Patents down; nevertheless, the danger existent that patents will become valueless or obsolete long before their expiration should be given weight.

When any of these assets are written down, such act should cause a charge against the Surplus account, rather than against operations.

Deferred Charges. — Fundamentally, an auditor should determine that the deferred charges do not include amounts from which the benefit already has been derived; if so, the debits properly should be absorbed by the Profit and Loss accounts. Deferred items may be set out in the Balance Sheet under a separate caption which will distinguish them from the current assets which are available for conversion into cash. The various items are vouched as are any expenditures.

The auditor's problem in connection with deferred charges relates primarily to the more doubtful items representing abnormal expenditures for advertising, etc., the benefit from which is presumed to extend over a period of time longer than the current one under scrutiny. Inasmuch as differences of opinion exist as to the treatment to be accorded these items, only a general idea of their handling can be attempted. Basically, the auditor should be extremely conservative so that current profits will not be overstated. It seems far better to write off these items too rapidly than too slowly.

Inventories of advertising supplies and materials, and of actual expenses covering advertising and publicity work from which benefit will be derived in the future may be treated as deferred assets. However, the auditor should be exceedingly careful in passing such items as deferred charges. Obsolete advertising materials have no value, and obsolescence hereover spreads rapidly. Current newspaper and magazine advertising should not be deferred, whereas, the cost of a special campaign involving heavy expenditures, the results of which cannot accrue until later, may be treated as a deferred expense. Whenever these items are deferred, subsequent operation should absorb them quickly, inasmuch as the asset value is violently uncertain.

Whenever production or sales is seasonal, a considerable amount of selling expenses occur a fair amount of time in advance of product delivery. Hence, in order that the period of delivery or sales may absorb the selling expenses which are related thereto, it is usual to defer expenses of this kind at the end of each period. However, the auditor should be most exacting in passing any amount hereunder shown, unless abnormal, in-

asmuch as where sales are fairly normal from year to year the expenditures as between years will be fairly uniform making a proration probably unnecessary.

If prorated, the same procedure should have been followed at the beginning of the period as is contemplated at its end. If this is not done, the adjustment being made only at the end of the current period, facts are misstated to a greater degree than would be the case where no adjustment at all is made. This same comment applies as well to all prepaid expenses. Again, the anticipated deferment should not at all be connected with securing current orders; further, the question of possible cancellation of orders requires consideration, as well as that which will attempt to determine how much of the expense actually was productive. Salesmen's traveling expenses ought never to be deferred. Whatever expenses are deferred should be charged off as deliveries are made.

Prepaid taxes seldom are encountered inasmuch as, usually, assessments are based upon the calendar year regardless of when payments are due. Special taxes, however, generally are paid in advance, so that a prepaid amount should be taken into account. In this connection, the tax receipt should be scrutinized for verification of the period covered.

Bond discount should be written off during the life of the bonds concerned. The procedure depends basically upon the retirement provisions of the issue, inasmuch as the same method used where a bond issue falls due all at once cannot well be applied to a situation where the bond retirement is annually or otherwise in portions. In order to audit bond discount (and bond premium) intelligently, the auditor should have some acquaintance with the principles of actuarial science. The account with Bond Discount should be analyzed; bond premium should not be included thereunder.

Prepaid rent should be written off during the periods benefited thereby. In auditing this item, the rent for the period under survey should be accounted for, this including the adjustment of the account at the commencement of the period if such account then existed.

Extraordinary expenditures covering repairs and maintenance of property assets should not be carried as deferred charges

unless, perhaps, due to the element of obsolescence; hereunder, some ground may exist for carrying at least a portion thereof as a deferred item — or booking same as a capital expenditure.

Where legal expense is deferred, the auditor should determine what it represents and how it is being written off. Any deferment thereof, generally, should not be for a long time. The account of Legal Expense should not hold current legal expenditures.

The Organization Expense account should represent exactly what it is supposed to contain, and provision should be made to write it off within a reasonable length of time.

Moving expense paid in advance requires no comment other than has been suggested in connection with other items supposedly of a deferred nature. As a deferred charge, this expense should be permitted to remain but temporarily upon the records.

Freight on consigned goods should not be abnormal in amount. The size of the account will depend upon the volume of the business and the nature of the transactions. Further, the account should not be permitted to act as a repository in which to bury items; commonly, also, the account is subject to considerable clerical error.

Deferred Charges to Operations: Federal Reserve Suggestions. — The Federal Reserve Bulletin has the following to say on the subject of deferred charges:

"Under this heading in the Balance Sheet are grouped such items as unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc. After the clerical accuracy of the deferred charges has been verified the auditor should satisfy himself that they are properly carried forward to future operations.

"Wherever possible, documentary proof must be produced in support of the items carried forward, as, for example, with unexpired insurance the policies must be examined to verify the dates of expiration, the amounts covered, and the proportion of the premiums carried forward; with royalties the agreements must be examined; with experimental charges the vouchers and particulars of the work done must be looked into, etc.

"The examination of the deferred charges will usually furnish the auditor with valuable information in regard to the accounts of the company, as, *e.g.:*

(1) The verification of experimental charges carried forward will

generally furnish information as to the production and future policy of the company.

(2) Royalty vouchers will generally furnish a check on the production of the mines.

(3) An examination of the insurance policies will show if the properties are mortgaged or covered by lien, and thus be an additional verification of the liability for mortgages on real estate, buildings, etc., shown in the Balance Sheet.

(4) The assets covered by insurance will be ascertained and if any omissions are discovered they should be mentioned."

CHAPTER XI

AUDIT OF THE LIABILITY ACCOUNTS

Introduction. — Although the discussion of the general principles underlying the verification of the assets has consumed considerable space, one should not assume that the comments offered in connection with auditing the liability accounts should absorb a proportionate amount, inasmuch as many of the fundamentals discussed in connection with assets may be applied to considerable advantage in the current instance. It is not the purpose to reiterate fully hereon.

Again, the auditor's attitude toward his problem may be emphasized forcefully. The clues that register upon his mind indicating the possibility of irregularities should not be passed over lightly, even though some of them at first blush seem to possess but slight significance. He should refuse to pass these, however unimportant they may be, until all means have been exhausted to determine their value. Under certain circumstances, a failure to diagnose properly may represent only the commitment of a professional error; again, the conditions may be such that the auditor may render himself liable legally for negligence. Even where the record of liabilities appears to be wholly in order, it would seem that he should hesitate before passing on to something else, ask himself the following questions, and be governed accordingly:

1. What search may be made outside of the books looking toward the discovery of hidden liabilities?
2. What possibility exists for the liability entries actually made being in error?

General Principles Underlying the Verification of all the Liabilities. — Certain principles seem applicable generally in verifying the liabilities, regardless of kind. To begin with, the internal checks in the accounting system with regard to having them recorded properly should be studied carefully in an attempt

to locate the weak spots; these latter should present clues as to the types of errors that might be made. For example, if the internal check over purchases seems entirely adequate, covering particularly the proper entry of purchase invoices, it may be assumed that errors which might occur here are improbable.

Again, reasonable search should be made for, and in, sources of information other than the books of account. If the attitude be adopted that the books, at best, tell the truth only in part, the auditor at least to this extent attempts to fulfill his obligations in connection with this angle of the case. For example, a hidden note of a considerable amount was uncovered by communicating with an out-of-town bank in which no deposits were then carried but whose name was dropped in the course of a casual conversation as to what banks other than local might finance a particular contract upon which bids were being prepared; in this instance, the interest payments had been taken care of outside of the books. Sources such as public records, banks, and terms on invoices and contracts should not be overlooked in this connection.

Conversation, or otherwise, as to the meaning of an accrual, in one case developed the fact that the bookkeeper was ignorant entirely of such items. Again, the scrutiny of one account, or of a transaction affecting a certain account automatically may register on the auditor's mind that a particular offsetting entry is required; incoming goods, for example, near the end of a period are to be debited to an Inventory account, and must be credited, therefore, to a liability account regardless of whether or not documentary evidence in the form of an invoice is on hand. The fact that title to an asset must pass to the purchaser before the asset can be booked properly so as to be offset by a liability suggests that certain assets may belong to a client even though not as yet on the premises; for example, goods in transit, usually, are not booked until such character is changed to goods in hand. Again, if the auditor ascertains the basic purpose for which his report is to be used, he can determine whether the possibility exists of encountering inflated liabilities or understated obligations; if a plan is on foot to have certain interests in the business sell out, liabilities may be inflated; whereas, if a credit report is desired, the liabilities may be understated.

The mere fact that a Balance Sheet shows a certain amount of obligations as being in existence should not cause an auditor to err in assuming that these are reflected by the books of account; even though the latter may contain everything in order, it is possible that the submitted Balance Sheet does not agree therewith and represents a false condition. Again, if an auditor determines the relationship of his client to the business under scrutiny, and then couches his Balance Sheet and report in simple and understandable terms, he may feel assured that what he states will not be misinterpreted or distorted by the person or persons who later have cause to read them. Frequently, book account titles are misleading, and the account arrangements upon the submitted statements as well; for example, one firm never would hire an auditor unless the latter promised in advance to set out *all* reserves merely as one item of appropriated surplus. Lastly, care should be observed to set out liabilities by classes in such a manner that their effect upon solvency may be secured; if current liabilities are small in amount as compared to current assets, but are all due in the near future, whereas most of the current assets, as accounts and notes, cannot be collected until some time later, a serious situation may exist even though a very fair condition may be shown by omitting the necessary information as to liability maturity dates and asset realization dates.

Notes (and Loans) Payable. — These written promises to pay, usually negotiable in form, may be issued to settle open accounts, in exchange for asset value — as cash or other assets, or in renewal of other notes. It seems in order, therefore, to trace them so that the auditor may satisfy himself that proper values were received or liabilities reduced, equal in amount to the notes issued.

In order to orient himself to the present problem, the auditor well may remember the following:

1. A record of notes issued may be found on the stubs of the books from which the notes were detached.
2. Record of insurance may be found in other books of original entry.
3. Notes may have been issued without any record thereof having been made.

4. Since it is necessary in a corporation for the directors to authorize the issuance of notes, the Minute Book may contain the requisite information relative to the amount of such obligations.
5. In a sole tradership or partnership, the lack of a record such as a Minute Book may mean that the determination of the amount of this liability assumes considerable difficulty.

The conditions encountered upon each particular assignment should be cogitated upon most carefully so that the proper protection may be had in the written report; under dangerous conditions, the facts should be stated in the report.

Upon the basis of the Cash Book, the auditor may prepare a list of cash receipts on account of notes (and loans) payable. Perhaps this was done at the time the receipts were vouched; usually, such will not be the case. The preparation of such list should be completed before any verification of this liability is attempted; next, this listing may be checked out against the schedule of notes (and loans) supposedly outstanding as of the date of the Balance Sheet under audit.

Notes and loans payable should be schedulized into two or three groups according to payee, as those covering loans, those covering prior obligations (as trade creditors), and notes given officers, employees, etc. Those which relate to loans have been given to banks, and perhaps to others — as note brokers, etc. Where money has been borrowed from banks or note brokers, it may be assumed that the basic purpose of the act was to use the money or its equivalent to reduce the accounts payable; hence, if such assumption is not warranted by the entries investigated, the purpose for which the money was used should be inquired into.

Notes covering loans are secured or unsecured. Each kind may be listed separately, notations being made as to date, creditor, due date, interest rate, amount, interest accrued to date of audit, interest prepaid at date of audit (if discounted), indorsers, whether original or renewal, and collateral security. Renewal notes should be mentioned, inasmuch as their presence warrants the suspicion that liabilities cannot be settled as they fall due. The scrutiny of the Minute Book should have produced notations as to Directors' loan authorizations, or for authority

given some officer to negotiate loans up to a certain amount. Notes and loans should be verified by correspondence and the request for information should be worded in a general way so as to uncover all in existence rather than those specifically recorded; further, there should be included a call for indicating all collateral held. After replies have been compared with the book record and the listing as prepared, the discrepancies uncovered should be adjusted as necessary. A properly worded inquiry frequently brings to light items other than those indicated by the books; again it may uncover the fact that the client is an indorser of notes as well.

Notes which have been sold to brokers should be verified by securing a report thereon; all cash received must be traced into bank. Such notes bear interest from date of sale. Notes sent to brokers for sale, but unsold, should be listed; these latter may be omitted from the Balance Sheet but, preferably, they should be shown thereon offset by a charge to the broker.

Canceled notes should be examined to make certain, among other things, that their negotiability is destroyed; if they are not available, the auditor should protect himself in his report. A scrutiny of the payment side of the Cash Book should present clues to notes not recorded (interest payments), with exceptions indicated above.

Notes issued against prior obligations must be considered carefully. Those covering contracts or purchases may be verified either from correspondence on file or by certificates secured from the holders should the files produce insufficient information. Notes related to purchases may be O.K., as where of large amounts, or they may indicate a strain of financial weakness; financial weakness may exist or there may be merely an improper provision for working capital.

Notes given for services rendered or presumed to have been rendered usually represent existing weakness since, ordinarily, services are paid for in actual cash or by check. Infrequently, the existence of such notes may be explained entirely to one's satisfaction as where, in a close corporation, notes have been given to officers in consideration of their not drawing salaries, in part at least. Nevertheless, each such note encountered should be examined most carefully so that its meaning is under-

stood clearly. It may be necessary in an attempt to clear up the matter satisfactorily to communicate with the persons who received such notes so as to secure their explanation thereof.

The Federal Reserve Bulletin suggestions covering notes and bills payable are as under:

> "Under this caption appear notes payable and drafts accepted.
> Schedules should be prepared under the subcaptions, and in columns headed:
> Date of making the notes or drafts
> Due dates
> Names of creditors
> Collateral hypothecated
> Additional indorsers
> Interest accrued to date of audit
> Notations of renewals (as information of this nature furnishes a guide to the state of the concern's credit)
>
> "The schedule must be compared with the Notes Payable Book and the total of the aggregate must agree with the balance of the Ledger account of Notes Payable.
>
> "Statements must be obtained from all banks and brokers with whom the concern does business, showing all notes and drafts discounted or sold by them for the benefit of the concern. These statements when received must be checked against the loans shown on the concern's books and approved in the minutes of the company.
>
> "Inasmuch as a note is a negotiable instrument, care must be taken to see that all of those recorded as paid during the year under audit have been properly discharged, and the cancelled notes are the best evidence of this fact.
>
> "Careful attention should be given to the collateral deposited for loans, and statements as to the existence of such collateral should be obtained from the holders thereof. Such hypothecation of any of the concern's assets should be accounted for on the Balance Sheet.
>
> "When practicable the auditor might suggest to the client the advisability of drawing notes payable on blanks bound in a book, like a Check Book, with a stub for each blank, the blank and stub to bear identical numbers. The officer, or officers, signing the notes could, in such case, initial the stub as a certificate to the amounts, payees, and terms of the notes issued. If this were done, the auditing of the bills payable would be greatly facilitated."

Accounts Payable. — The auditor's attitude toward the accounts payable should be that only infrequently will an overstatement occur; more particularly is an understatement apt to be encountered — as where no satisfactory internal check exists

over purchase invoices, where credit or a loan is desired, etc. Accounts payable that come into existence through the purchase of materials and supplies, in the usual course of events, either are recorded in an Accounts Payable Ledger or are handled upon a voucher system basis. Hence, the audit of this liability, as to procedure, seems to depend upon which variation is encountered, particularly so in the approach made.

In the event that an Accounts Payable Ledger is operated, the first contact may be indicated about as under:

1. Secure Trial Balance (or abstract) of the Ledger (or prepare one).
2. Verify account balances.
3. Compare such balances with Ledger abstract.
4. Agree abstract total with that on the General Ledger Trial Balance (or Balance Sheet), and with the total of the controlling account. If a control does not exist, one may be constructed.

Where a Voucher Register is found without an Accounts Payable Ledger operated in connection therewith (as is apt to be the case), the following variations in attack are of interest:

1. Secure list of accounts unpaid and outstanding (or prepare one); if prepared, such list may be constructed in any one of the following ways:
   a. List the unpaid vouchers in the file:
      i. Check this against the open items in the Register, or
      ii. Do not thus check.
   b. List the open items upon the Voucher Register (omitting the file contact).
2. Total the open accounts thus listed and agree such total with the controlling account balance, and with the statement balance.

The unpaid items are analyzed profitably to:

1. Exclude all which are not trade accounts — not true accounts payable. It is to be remembered that "accounts payable" as a term may be of general significance only, the individual accounts differing in their character.
2. Exclude all which have debit balances, these presumably representing recharges, overpayments, etc. The total debit

balances, after verification should be set out in the Balance Sheet as accounts receivable. This separation and display are demanded so that the exact situation with regard to the accounts payable and accounts receivable may be shown; one class ought not to be used as an offset against the other.

Frequently, it may be desirable, commensurate with time and circumstances, to age the accounts. The reason for doing this is to determine whether the credit of the business is being unduly stretched, and to ascertain the current need for funds. Accounts which are past due, but not in dispute, require a separate Balance Sheet set out; those which are in dispute should be investigated sufficiently to determine their exact status. In fact, all the accounts should be scrutinized so as to ascertain their exact character. If any accounts are past due or if discounts for cash or early payment have been neglected (not being regularly taken), it seems fair to assume that the concern's financial policy is at fault — perhaps the business is on the verge of insolvency; usually, it is considered to be profitable to borrow money somewhere to take advantage of discounts.

Not only does it appear to be a good practice, where feasible, to circularize the accounts payable creditors, who do not send in statements in regular course, in attempting to verify balances, but such act should be done with every disputed account; in fact, if the privilege of doing this is denied, free access to the correspondence files is in order and, in the event of failure to secure this privilege, the report ought to be qualified accordingly. A comparison of creditors' statements with account balances should not be neglected since such procedure may uncover unrecorded liabilities.

Some examination of the cash payments record should be made to unearth invoices paid in periods other than the one to which they belong. Frequently, invoices applicable to the last month of a fiscal period, received late, are omitted from the books entirely, being paid and booked at some later time; hence, this matter should receive attention as of both the beginning and the end of the audited period. Just how far the auditor's examination should proceed along these lines seems difficult to state, as conditions vary, but a general rule to follow would seem to be that he should scrutinize carefully all vouchers for the first two or three months of the period under audit and for the two or three months following the close of such period. By doing this, items which have no bearing on the audited period may be excluded, whereas those which relate thereto may be included.

The Federal Reserve Bulletin suggestions covering accounts payable are as follows:

"A list of balances due on open accounts must be prepared and carefully checked with the Ledger accounts, care being taken to see that no open account on the Ledger has been omitted from the list. It should be ascertained that the balances represent specific and recent items only. When an account does not appear regular a statement from the creditor should be obtained. If there are many such accounts in dispute, and they amount to so large a sum as to affect appreciably the total of current liabilities, the general causes for the disputes should be inquired into and note made of the matter for the consideration of the banker.

"In concerns with modern voucher systems accounts payable are easily verified, as all liabilities are then included in the books when incurred. Care should be taken, however, to see that all goods received on the last day of the fiscal period, as shown by the receiving records, and also all goods that were in transit and belonged to the concern on that date, are included as liabilities, and the corresponding assets included in the inventories. This test is necessary, as an increase in the accounts payable may have a very important bearing on the financial position of the concern if the cash on hand is small."

Accrued Liabilities. — Except possibly where a business operates upon a cash basis, accrued liabilities must not be forgotten (and preferably in the first instance also), so that they may be placed in the Balance Sheet to set out the financial position properly. The offsetting debits involved affect the operating statements. Where a satisfactory system of bookkeeping is encountered, the liabilities are absorbed by the accounts as rapidly as bills are approved for payment, and accruals usually are not forgotten; on the other hand, if indifference, carelessness, and laxity are encountered, numerous accruals will be found to exist and, owing to the manner in which the liabilities are brought into the accounts, considerable difficulty may be experienced in determining the proper accrued amounts. In certain cases, the exact amount of the liability is determinable; in others, an estimate is in order. However, if the audit is made sufficiently beyond the close of the period under scrutiny, the exact amount of all accruals should not be a difficult task to determine.

Interest accrued, ordinarily, is verified when the liabilities carrying interest are examined — as bonds or mortgage payable, and notes payable (covering loans running beyond the period being examined). Interest on overdue accounts payable should be taken up. In certain cases, items representing such liabilities will be found upon the books — as where bond interest is booked monthly; in others, the books are clear of such. In any event, the liability booked must be verified, or its amount calculated so that entry may be made to cover. Whenever confirmation is asked from the holder of an obligation in verification thereof, inquiry should be directed, also, toward ascertaining the amount of interest accrued thereunder. Interest accrued on notes payable, on bonds payable, and on overdue accounts payable should be set out separately in the Balance Sheet. Taxes which are overdue, liens, and judgments carry interest.

The verification of interest accrued on bonds outstanding should be made at the time the interest paid thereon is ascertained through coupons or checks canceled (see bonds, *post*). For example, Interest on Bonds account is debited and Interest Accrued on Bonds account credited, for a certain amount, and then a special deposit is placed with some financial institution equal in amount to the bond interest. As coupons or canceled checks are returned by this fiscal agent, the Interest Accrued account is debited and the special cash account is credited; hence, the special cash account balance should equal in amount the interest accrued but unpaid. The cash balance is verified in the usual way shown previously, after which the amount thus reported is checked by totaling the coupons or checks as yet outstanding. The above comments apply, on the whole, to both coupon and registered issues; as to the latter, checks are encountered, not coupons. Considerable variance in situations may be met with, some not being as simple of solution as the above, as where an interest period does not terminate on the end of the company's fiscal year; hereunder, the account with interest accrued may indicate two things — interest accrued due but unpaid, and interest accrued not due.

Where dividends declared are unpaid as of Balance Sheet date, the liability therefor should be set up inasmuch as under

such a condition payment thereof can be forced by the Court; in nature, they seem similar to interest accrued. The Minute Book should show each declaration, and the other records would show the payment; dividends are paid by check. The dividend liability is current even though the declaration was made on the last day of the company's operating year. The auditor's prime concern with respect to dividends is to satisfy himself that the declaration was entirely lawful and proper, — that they are not to be, or were not, paid out of capital. In the event that profits have not been earned, and a declaration is made, those interested can follow whatever was paid out and, legally, compel a refund; and where such refund fails, the directors of the company may become personally liable. Further, the fund on deposit should equal the liability. Basically, the verification procedure is similar to that where interest has been paid by check. Cumulative dividends should be indicated on the Balance Sheet as a footnote thereto.

Wages accrued frequently are not found on the books, this condition requiring the auditor to set up the liability therefor; particularly is this non-booking encountered when a voucher system is not in operation. The adjustment made may be done on a fractional basis rather than through a detailed analysis of all the time cards. Naturally, an adjustment at the end of the period cannot be considered as completing the requirement; the same adjustment should be recognized at the period's beginning.

The comments just above apply equally well to salaries. It is necessary hereunder not to omit salaries of traveling salesmen or agents.

Taxes, regardless of the times of the year at which payable, accrue as time passes. The taxes accrued may be determined in part from an examination of the tax receipts for the previous year or period antedating the one under audit. Where property additions have not been made prior to the current period's assessment date, or where the tax rate has not been changed, the tax should be the same amount as before. Where such changes have occurred, the current assessment may be verified by communicating with the local authorities. Further, the auditor should satisfy himself all taxes prior to the year examined have been paid. If taxes happen to be taken up in the books month

by month, the total at the end of the year or period being audited, as a liability, should be correct. Provision should be made, as a liability, for Federal and State income taxes.

Gas, water, and electricity rates often are paid quarterly or semi-annually. At the end of a period, should any of these have been used but no payment made to cover, an accrued liability exists for entry on the Balance Sheet; however, pending receipts of bills, an estimate of the amounts is necessary.

Sundry accrued liabilities for traveling expenses, commissions, legal or accounting service, damage claims, and for expense bills of whatever nature should not be forgotten, as so often happens. At times, for some of these, bills will be on hand unpaid and, again, no bills at all will be available. Traveling expenses may be secured from expense reports rendered or paid just after the close of the period audited. Commissions on sales are due as soon as goods are shipped and billed, even though a particular practice may exist of not paying the salesman until after the customer has settled his account. The liability for unpaid attorney's or accountant's fees, at times, cannot be secured except from the Minute Book which may show litigation in progress, and from the auditor's own knowledge of what services he has rendered. The liability covering damage suits not covered by insurance, also, may not be shown anywhere except in the Minute Book. Claims for damages, where conceded by the attorneys, should be provided for by means of an accrual; but where the suit outcome is questionable, a reserve to cover should be provided.

As a final precaution, after having scrutinized Minutes, unrecorded invoices, bills covering goods in transit or goods received near the beginning of the subsequent period but applicable to the audited period, consignors' accounts and statements, etc., the auditor should secure a certificate from a responsible officer that all liabilities for purchases, expenses, etc., have been taken up in the books, and that no claims, liens, or suits exist against the business.

Deferred Income; Contingent Liabilities. — Receipts of cash paid in advance of being earned, representing a portion or all of the consideration underlying a contract entered into to be performed in the future, should be treated as deferred income — as a liability of the audited period to be applied against the income of future periods. This would be true, for example, in the case of subscriptions paid in advance for newspapers or periodicals (to a publishing house), tuition paid in advance to a school, deposits made where goods are to be manufactured under special orders, etc. The failure to record such liabilities as the above, assets of some kind having been received, causes the profits of the period to be inflated by the amount involved.

On the other hand, contracts may be in existence which are entirely executory from the viewpoint of both parties, as where orders have been accepted for future delivery (open market orders) or where something is to be erected but payment denied until partly or fully completed. Although such obligations may not be recorded in regular course, the liability thereunder exists, and care should be observed to unearth such. In the present instance, the danger of inflating profits need not be considered since no asset of any kind will have been received that requires booking as would, say, cash. Frequently, the only sources of information available to the auditor are the correspondence files or the files of contracts on hand. Even though he may be in favor of omitting such liabilities from the Balance Sheet, the always existing possibility that one or more of such items may result disadvantageously to the audited concern seems a basic reason for their inclusion in the Balance Sheet in some manner, even if no more than referring thereto in a footnote. Further, if possible, the report should contain some comment as to whether such contracts seem of value to the business or appear of questionable worth thereto.

Contingent liabilities, such as discounted notes receivable, accommodation indorsements, warranties and guaranties, signing of a surety bond, etc., should be recognized and provision made to indicate such in the Balance Sheet. In some cases, it may be entirely satisfactory to refer thereto by means of a footnote; in others, a regular entry procedure should be followed (as for discounted notes); and in others, it may be desirable to cover them by means of a reserve. In fact, the last two methods of treatment are to be preferred to the first; the first method of handling seems to be somewhat of a makeshift.

Fixed Liabilities. — Some contract, deed of trust, or lien evidences the existence of a fixed liability; the term comprehends mortgages, bonds, and sundry liens. Mortgages are not often found except as security for notes — the mortgage covering real property as land or land and buildings, or personal property as chattels. The former is more apt to be encountered than the latter except where either temporary or permanent financial difficulty has attacked the client concern.

Since the power of mortgage creation, in a corporation, rests with the company's Board of Directors — unless the by-laws or state statutes prohibit — the Minute Book should contain references to their existence. Next, copies of the mortgage should be read and copious notes made thereon in tabulated form as to amounts due, due dates, interest rates, properties covered, etc. Inasmuch as the mortgagor may be required to do certain things under his agreement, such reading will permit the auditor, also, to determine whether these requirements have been met. The public records should be searched for mortgages therein recorded, and for payments which have been made to apply on account; legally, if payments made on account to reduce the original amount are not recorded, the property incumbrance has not been reduced. In such case, the recorded lien should be shown in the report with the deductions covering unrecorded payments subtracted.

Next, it should be determined that the mortgage interest has been paid as agreed, and that the interest accrued has been considered; unpaid mortgage interest is an additional lien against the property covered. A note should be placed upon the Balance Sheet covering properties mortgaged; or the pledged property may be set out separately in the body of the statement.

In order that the auditor's report may be as luminous as possible, the object of mortgaging each piece of property should be known to the auditor. Mortgages should not be given to a corporation official for services rendered; and they should not be given to a creditor as security to the damage of other creditors. Whatever was received as a result of placing a mortgage should be traced into the records.

Bonds, in effect, are secured promissory notes usually falling due a number of years subsequent to the date thereof — anywhere from five years upward. The shorter term bonds are common to industrial enterprises, whereas the longer term issues are found commonly in the public service field. In the latter instance, upon maturity it is frequent practice to effect a renewal thereof so that the funds secured thereunder may be considered as permanent in their nature but, nevertheless, a loan rather than a capital investment. In fact, all bonds, regardless of the type of lien security involved (first, second, or etc.) are a liability different from others only as to security, manner of payment, and date of maturity.

Bond security usually is by trust indenture, or mortgage in favor of a trustee (some trust company or banking institution) who is given the power, when payment of interest or principal is defaulted, to institute foreclosure proceedings in behalf of the bondholders. The property securing a bond issue may be either real or personal.

To begin with, both the bond and a copy of the mortgage should be read most carefully, the relation of each to the other being observed. The mortgage should be read as to the wording of the bonds, date of issue, par of each bond, their security, how redeemed, and special provisions. The amount of the property covered by the mortgage securing the bonds should be determined so that which is unliened may be stated separately in the report; frequently, the liened properties are indicated in a Balance Sheet footnote. Properties not covered by the mortgage represent potential borrowing strength. Further, the auditor should determine the lien priorities in favor of each bond issue in existence. The security specified should be ample. And it should be determined to what extent the mortgagor has met the particular requirements laid down to be fulfilled.

Perhaps some small attention should be given to a bond issue as to whether the bonds are coupon or registered. Coupon bonds contain no information as to the ownership thereof, the issuing company evidently caring nothing about this; registered bonds, on the other hand, are registered with the company or with someone titled "registrar" so that the issuing enterprise knows to whom the interest is to be paid. Primarily, the only difference between a coupon bond and a registered bond relates to interest payment; a coupon bond has interest coupons attached

thereto when the bond is printed, whereas, in the case of a registered bond the interest is paid by check.

The bonds outstanding may be verified in a number of ways and it may be advantageous for the auditor to apply more than one of them. However, all of these methods cannot be applied indiscriminately to both coupon and registered bonds. For both types, if cash has been received in payment therefor, verification may be made through the Cash Book; if payment was received in the form of some other asset, some other related record (as the Journal) will be scrutinized. The bonds unissued may be accounted for, after which the remaining portion of the issue may be assumed as outstanding provided none are out as collateral.

If the bonds are coupon bonds, the coupons may be used in ascertaining with fair accuracy the outstanding principal; if all interest coupons for past periods have been redeemed, as covered by the Cash Book, it should not be difficult to determine the amount of the principal upon which interest was paid. Each coupon carries a number corresponding to the number on the bond from which it was detached. After the coupons have been paid and returned, by sorting the numbers in sequence, and by observing the period covered by each coupon, the amount of bonds outstanding may be determined. The bonds outstanding and the interest paid thereon may be verified from trustee's receipts on hand, these having been received when interest installments were paid over to him.

In the case of registered bonds, the returned checks may be used for verifying both principal outstanding and interest payment. Where all holders are registered, a certificate from the registrar should establish the outstanding amount; again, the Bond Register may be used for this purpose.

Bond scrip outstanding, calling for the issue of bonds, should be verified and its amount added to that of the outstanding bonds to ascertain the total liability.

If bonds in the treasury have been signed by the officers, their amount should be set out as treasury bonds so that the treasurer may be charged with their custody. After verification, their amount should be shown in the Balance Sheet as a deduction from the total as issued. Where treasury bonds have been hypothecated to secure a loan, a Balance Sheet footnote should be made covering such deposit as security, inasmuch as if the loan should not be repaid, and the bond security should be sold as a result, the part of this block of bonds becomes the liability rather than the loan amount.

Where bond retirement is provided for through the use of a sinking fund, the agreement covering its creation should be scrutinized to ascertain that its provisions are being met; if failure is noticed in this regard, the extent thereof should be commented upon. Bonds which have been redeemed should be inspected to determine that the cancellation was made properly; the amount thereof may reduce proportionately the recorded lien. or it may not.

The Federal Reserve Bulletin suggestions concerning the audit of bonded and mortgage debt are as under:

"A copy of the mortgages must be examined and the terms thereof noted. The amount of bonds registered, issued, and in treasury, rate of interest, and duration of the bonds, should be shown on the face of the Balance Sheet. A certificate should be obtained from the trust company certifying the amount of bonds outstanding, etc., as verification of the liability stated in the Balance Sheet. The interest on the bonds outstanding, shown in the Balance Sheet, should be calculated and reconciled with the interest on bonds, as shown in the Profit and Loss account.

"Sinking fund provisions in mortgages should be carefully noted and care should be taken to see that they are provided for in the accounts of the company, and any default noted in the Balance Sheet.

"Bonds redeemed during the period or previously should be examined to see that they have been properly cancelled, or, if they have been destroyed, a cremation certificate should be obtained from the trustees.

"Mortgages sometimes stipulate that the current assets must be maintained at a certain amount in excess of the current liabilities, and the auditor must give due consideration to such matters and any other stipulation in regard to the accounts, or any audit thereof, that may be referred to in the trust deed, and see that they have been complied with.

"Mortgages. — As a mortgage derives its chief value from the fact that upon registry it becomes a lien, the auditor should verify the existence of such an obligation by inspecting the public records, not only with reference to such as may be found on the company's books, but also any that may appear on the public records as unsatisfied. If the auditor lacks the necessary facilities for making a search it will be worth his while to arrange with a local lawyer or title company whereby, for

a small fee, any mortgages or judgments entered against the concern under audit will be reported to him.

"In any event the auditor must verify the amount as recorded in the account, the rate, the due date, and the property covered thereby.

"It should be borne in mind that a payment on account of a mortgage must be recorded or the entire amount will remain as an encumbrance on the property. Therefore, if payments on account appear, the auditor should ascertain if they have been so recorded; if not, the fact should be noted on the Balance Sheet.

"Judgments. — The same procedure should be followed in verifying judgments as in verifying mortgages. As many business men consider that the entry of an invoice is an admission of liability, and will not permit the entry of a claim which they propose to fight, it is sometimes difficult for an auditor to find evidence of such liens. Even admitting the fact, they may still refuse to allow the judgment to be entered on the books as a liability, in which case it is proper for the auditor to include it as a footnote on the Balance Sheet as a contingent liability.

"Unpaid interest. — When considering the matter of liens it should be noted that interest unpaid is a lien as well as unpaid principal, so where the auditor finds evidence of interest on liens being in default, he should add it to the principal in each case."

Conclusion. — Sometimes, the various methods commented upon above may fail in uncovering all existing liabilities, as perhaps mechanics' liens. Where circumstances justify the procedure, it may be desirable to secure access to the correspondence files; but more often than not such access will be refused. Under such conditions, the auditor's report should be particularly qualified; and, in general, it would seem that frequent occasion arises under which the auditor will do well to qualify his report as to the exact basis on which his conclusions rest.

CHAPTER XII

PROPRIETORSHIP; RESERVES; INCOME AND EXPENSE

Capital. — Proprietorship accounts correspond to the types of business units — those for sole traderships, those for partnerships, and those for corporations. Under any of these forms of business, the variations encountered in these accounts relate merely to a separation and transfer.

A sole tradership reflects proprietorship or net worth in one capital account — the investments and the profits or losses year by year being passed thereto. Since the individual operates alone, he is responsible alone for his acts and obligations. The investment and profits belong to him and, should circumstances demand, as where his invested funds are insufficient to meet creditors' claims, his other personal assets, exclusive of the legal exemptions, may be liquidated for payment thereof. An audit of the accounts of a sole proprietorship may differ in no way from the audit of a partnership or corporation so far as assets and liabilities are concerned. The Capital account, however, should be analyzed so that there may be shown its beginning condition, changes due to capital additions and withdrawals, and to profit and loss effects.

The above considerations apply in a like manner to the capital accounts of a partnership, except that in this latter instance more than one such account is found, and responsibility, as a rule, is divided. The capital accounts of a firm, reflecting diffused responsibility, indicate the existence of numerous restrictions. Because of this, the contents of partnership contracts and agreements made later supplementing the former ones originally in existence, should be familiar to the auditor as a basis for his work in the present connection. Hence, in addition to verifying the usual items common to all concerns — assets and liabilities — the auditor should scrutinize closely all accounts carried with

each partner, emphasizing in connection with the matters therein displayed a strict compliance with the agreements in force.

Early in this book, brief comment was made concerning the reading of the partnership agreement, or the minutes (if a corporation), and the making of intelligent notations thereon. In the case of a partnership audit, when the auditor is ready to commence his examination of the capital accounts, he must acquaint himself again with what was deduced therefrom, particularly as to:

1. Agreed-upon capital contributions
2. Allowance of interest on capital; interest chargeable on drawings
3. Partners' salaries and drawings
4. Sharing of profits and losses

in order that he may be assured that the agreed-upon provisions are reflected properly in the accounts.

In a corporation, the capital invested by the stockholders is recorded separately from the undistributed earnings. The capital stock accounts should represent only the par total of whatever shares of capital stock have been authorized by the State. Increases or decreases in proprietorship due to profits secured or losses incurred are taken care of in one or more surplus accounts or in a deficit account, and in certain reserve accounts.

The corporate charter, or certificate of incorporation, is of auditing import since therein are set out the company objects and powers. By being acquainted with these, the auditor is in a position to determine whether or not *ultra vires* acts have taken place, and to ascertain whether or not stock issues, stock preferences, and many other matters have been taken care of correctly. The corporate by-laws are of importance to the auditor second only to the incorporation certificate. And last, but also of great importance, is the Minute Book.

In a corporation, notations will have been made relative to the contents of charter, by-laws, and minutes on matters of probable audit import. Prior to auditing the capital stock accounts, many of these notations must be reviewed in order to freshen the memory thereon, as:

1. Authorized capital stock.
2. Factors underlying sale and disposition of capital stock — especially price and terms. Premium received from sale should be set out so that it will not be distributed as dividends. The contact with discount raises the question of the stockholders' liability under statute in the amount of such discount.
3. Extent of values received where stock is issued for property or services. In any event, regardless of consideration, the latter must be legal under statute and full value must have been received and have been accounted for properly.
4. Particular provisions supposedly carried out correctly as to maintenance of a certain ratio between fixed and current assets, the creation of specific reserves, etc.

Capital Stock. — It would seem that the auditor's efforts hereunder should lead to the correct statement of each kind of capital stock in the Balance Sheet — as to amount, authorized, issued, and in the treasury. The amount of each authorized issue may be verified from the incorporation articles and, if additions have been made to the original amounts, each such should be authorized by the minutes, and by the State. Further, the minutes should be scrutinized to determine whether or not the issue requirements have been met.

If there is but one class of stock in existence, but one account will be carried therewith in the General Ledger, this usually holding the par value thereof. In case two or more classes of stock are in existence, one account should be opened for each in the General Ledger. Where the law requires that a Stock Book be kept (as in New York), in which each stockholder has an account showing name, address, shares issued to him, etc., a scrutiny of this record appears in order to ascertain that its upkeep conforms to statute.

In the audit of a large company, it is usual to encounter transfer agents, ordinarily, trust companies. Under such a condition, it would seem sufficient to secure from such transfer agent a certification of the capital stock outstanding. On the other hand, where a transfer agent does not exist, and the stockholders are numerous, the stock transfers, as a rule, are not checked out completely; but it would seem that all original issues should

be traced to the transfer records, after which the total amount outstanding may be proved along the lines indicated below.

The verification of the capital stock outstanding, briefly, may be accomplished in either of two ways. On the one hand, the auditor may draw off a list from the open stubs in the Stock Certificate Book for both common and preferred showing, as to each certificate outstanding, the certificate number, and the number of shares represented by each stub. The total of this list should agree in amount with the total of the capital stock shown on the General Ledger as being outstanding. On the other hand, an abstract (or so-called Trial Balance) may be drawn off the Stock Ledger (Stock Book) showing stockholders' names and number of shares held; the total thereof is agreed with the General Ledger. Information should be available on each list, also, as to authorized amount, par value per share, total par, market, and book values.

The Stock Certificate Books should be thumbed through and the numbers on the blank certificates unissued scrutinized to ascertain that no blank certificates have been removed. The stubs in the Certificate Book may show signatures of stockholders signifying receipt of the shares of stock; otherwise, slip receipts should be on hand containing the same information.

Where Stock Exchange securities are involved, a certificate should be secured from the registrar; the latter's existence is an Exchange requirement. Such certificate will assist materially in establishing the issued amount which has been listed and is dealt in on the Exchange; it may not establish completely all of the company's stock outstanding — a different issue may not be listed.

Transactions causing the establishment of treasury stock, as by donation for working capital or by purchase, should be examined to ascertain that they follow the law, and the resolutions of the stockholders and directors. The treasury stock may be verified by actual inspection. When the Balance Sheet is prepared, ordinarily, its amount should be deducted from the total authorized issue along with the unissued portion; treasury stock on hand seems to be nothing more than a right to extend the proprietorship. Irrespective of par, it is assumed that treasury stock may be sold at any price; nevertheless, if sold for less than

its cost to the company, a comment in the report is in order inasmuch as poor financing is shown thereby. Stock authorized but unissued should be distinguished from treasury holdings.

Where stock has been sold upon the installment plan, it should be determined that the approval of the Board of Directors is in order thereover, and that the calls made have been passed along properly to the stockholders. Any stock issued, but not fully paid for, should be examined closely, and certificates secured from the subscribers acknowledging their liability to the company.

If canceled certificates are not recorded properly, the exceptions should be listed. Proceeds from the sales of any stock made during the period under audit should be verified. If preferred stock outstanding carries the cumulative feature, the Balance Sheet should contain a comment covering the dividends accrued, not yet declared.

The Federal Reserve Bulletin offers the following suggestions concerning the capital stock phase of a Balance Sheet audit:

"As a rule trust companies are the transfer agents for the capital stock of large corporations and for verification purposes it is sufficient to obtain letters from them certifying to the capital stock outstanding.

"Where companies issue their own stock, the Stock Registers and Stock Certificate Books should be examined and compared with the lists of outstanding stockholders.

"On the Balance Sheet each class, if more than one, of stock must be stated, giving amount authorized, issued, and in treasury, if any. In the case of companies with cumulative preferred stocks outstanding a note must be made in the Balance Sheet of the dividends accrued but not yet declared.

"If stock has been sold on the installment plan, the auditor should ascertain that the calls have been promptly met and whether any are in arrears. If special terms have been extended to any stockholder, approval of the Board of Directors is necessary and the minutes should be examined accordingly.

"If any stock has been sold during the period under audit, the auditor should verify the proceeds of the sales."

Opening Entries. — In connection with the verification of the capital element, care should be used in determining the exact effect of the opening entries thereon, and that the agreements entered into have been properly carried out. In the case of corporations, the auditor should make certain that the laws of the

State under which the company is formed have been met; the accounting records should conform to the statutory provisions.

In order to determine whether the issues and transfers of stock at the opening time have been entered properly, it is necessary to scrutinize the Stock Book particularly to uncover manipulations with so-called dummy incorporators. The shares issued to these must have been actually subscribed for and paid in, and certificates issued in their names. Should a defect hereunder be uncovered, a report thereon is essential. Again, if a corporation receives cash, property, or services in payment of its stock, that which was received should be worth the par of the stock issued, at least in the minds of the directors (in New York). Goodwill, as an asset, in the absence of fraud, will support an issue of stock.

Subsidiary Company Holdings. — The correct financial condition and earning results of a company which controls another through stock ownership cannot be ascertained except by viewing the combination as a whole, this necessitating the elimination of stock ownership. In a case of this kind, a Consolidated Balance Sheet should be prepared. If the amount of stock held by outsiders in the controlled company is small, it may be set out in the consolidated statement at par although where possible, the takeup at book value seems preferable. Along similar lines, intercompany profits should be eliminated.

In a complete audit, the financial accounts of each subsidiary should be examined in addition to the verification of the stock issues thereof. Only in this way does it seem possible to uncover questionable procedures in the subsidiary records.

Reserves. — The auditor should differentiate clearly between the two basic types of reserves, and ascertain that the distinctions made are clearly drawn. A portion of surplus may be found in accounts carrying reserve account names, having been appropriated thereto so as not to be available for dividends; again, a reserve account may represent a loss or expense which has occurred already or which from experience is considered as being inevitable.

Reserves against estimated losses are not the same as reserves from profits. The former type is presumed to represent a reasonable part of the Profit and Loss account held on the records

until the actual amount of the expected loss is determined; these reserves on the Balance Sheet should be deducted from the assets to which they are related, both to show the net holding value of each such asset and to eliminate possible interpretation thereof as true reserves set out on the opposite or right side of such statement. In passing upon the amount of such reserves, the auditor should incline toward extreme caution rather than toward optimism.

A true reserve represents profit set aside in such a manner that it is withheld from distribution; the reason therefor may be general or specific; for example:

1. Reserve for contingencies
2. Reserve for accidents
3. Reserve for construction
4. Etc.

It is the auditor's duty to ascertain that such reserves have been authorized properly by the directors — such authorization appearing in the minutes — and that they are being carried into effect in accord with expressed intentions. True reserves never should be set up unless authorized by the directors.

Inasmuch as sinking funds and bonds have been discussed previously, a word on the sinking fund reserve appears in order. Where a sinking fund reserve is created to retire a liability out of profits that are not to be distributed, it measures a portion of true profit; the amount thereof is concerned with a particular purpose. After the sinking fund agreement is ended, the reserve therefor may be transferred back to unappropriated surplus since a liability has been met from profits.

Surplus. — As a term, surplus may be defined as the amount by which the assets of a corporation, valued properly, exceed in amount the capital and liabilities. Surplus and true reserves basically are the same, except that true reserves have been authorized and appropriated officially whereas surplus represents undistributed profit — profit unappropriated and not reserved officially.

The balance in the Surplus account represents profits accumulated but not appropriated to true reserves or declared in dividends. The various profit and loss accounts should reflect only

the operations during each current period; any balance remaining in the summary Profit and Loss account at the end of each period should be transferred to the Surplus account.

Inasmuch as the Surplus account is affected by almost all of the Balance Sheet group of accounts, it seems proper that a most careful scrutiny and analysis thereof should be made by the auditor over as many accounting periods as possible so that a general idea may be secured by him as to the profitableness of the undertaking under review. Further, an analysis thereof should show just what is contained therein. If the surplus at the beginning of the period under review does not agree with the Ledger or with the amount reported on the former statement, a reconciliation seems in order showing full details of the existing differences.

Inasmuch as the capital stock, surplus, and true reserves, when added, measure the book worth or ownership of the stockholders in the company, theoretically it would seem good accounting to bring these various elements together in the Balance Sheet so that the aggregate thereof may be shown in one amount as the difference between the assets and the liabilities (the stockholders' net equity). Practically, however, the above method of set-out is seldom found in published reports.

The Federal Reserve Bulletin offers the following suggestions as to the surplus item:

> "The auditor should give consideration to the surplus at the beginning of the period. This item represents the accumulated profits prior to the beginning of the fiscal period under review, and should be compared with the surplus shown on the Balance Sheet of the previous year, and with the Ledger account, to see that it corresponds, and if it does not, a reconciliation statement should be prepared giving full details of the differences."

No Par Value Capital Stock. — The audit of the capital stock without par value may or may not cause the auditor considerable trouble. As a basic proposition, it is generally assumed that the verification, schedules, and certificates to be secured differ in no way practically, from those concerned with stock which has a par value.

Since the elementary principles underlying no par value capital stock are set forth generally in numerous recent books on accounting theory, it seems unnecessary in the present connection to recapitulate in full, but merely to indicate briefly certain matters which may be of general interest to the auditing student.

In 1912, New York amended its stock corporation law so as to permit the issue of common stock without par value (*Stock Corporation Law:* Sec. 19). Since then similar laws have been enacted in some twenty-five other states, these differing one from the other in certain particulars. All permit the issuance of common stock without par value, but some specify a minimum share price below which the stock cannot be sold; New York, for example, specifies that shares cannot be issued for less than $5.00. Again, others require the corporation to declare the amount of the fixed capital with which the corporation will do business, and which it will not impair by the declaration of dividends. All laws require that the stock certificates shall carry the number of shares actually represented by them; and some specify that the total authorized number of shares be shown upon the certificate as well.

Dividends upon stock of no par value must be stated in a money amount per share, since no par value exists as a basis for a percentage set-out. The statute provisions covering dividends vary considerably, the following being illustrative:

1. The amount paid in cannot be reduced by dividends.
2. The assets and liabilities must bear a certain ratio to each other before dividends may be paid.
3. A declaration must be made as to what shall be the permanent capital, this not to be less than a certain amount per share. In these instances it may be assumed, at least theoretically, that all excesses beyond such amount may be paid out as dividends; inasmuch as the legal angle here involved has not as yet been definitely settled, the above assumption actually may be in error.

In the case of stock with no par value, all proprietorship in the Balance Sheet may be allocated under the heading of Capital and Surplus provided, however, that earned surplus be shown thereon as a separate item, just as happens in the case of stock with par value. Usually, though, the value of the capital stock of no par

value is represented as the excess of capital and surplus, or of capital by itself in case the shares represent original issuance.

In a lesser number of states, but still in more than half of the twenty-five or so, preferred stock may be issued without par value. And it is in connection with cases where no par value stock is both common and preferred, that serious trouble may be encountered, particularly relative to the rights of each class of stockholders; if the preferred stock is preferred as to assets as well as to dividends, the amount to which the preferred holders shall be entitled at dissolution, before the common stockholders get any payments, is a serious problem unless the certificates cover the situation — which frequently is not the case.

Many persons apparently are in hearty accord with the use of no par value capital stock. If this were not so, legislation on the subject would not be in force in as many states as actually is the situation. Nevertheless, it appears to be an unsettled question as to whether or not no par value capital stock actually has the advantages claimed for it. For example, sponsors of the idea of no par capital stock claim that thereby the evils of over-capitalization would be obliterated; but note what M. B. Ignatius has to say on this point:

> Standing by itself, the removal of the par value "does not interpose any obstacle to the practices which have been the means of working over capitalization heretofore . . . the omission of par value is not a remedy sufficient in itself to cure the existing evils; to be effective, it must be accompanied by intelligent and constructive control over organization and administration, and an active governmental control of accounting. . . ." (*Financing of Public Service Corporations.*)

Again, John R. Wildman, C.P.A., has this to say concerning no par value preferred stock:

> ". . . it may be issued at any price which the directors deem desirable, unless the price is in some way restricted by resolution or by-laws, and still be full-paid and non-assessable. Careful consideration of the matter fails to disclose any other advantages." (*The Certified Public Accountant*, January, 1923.)

In order that the student may investigate this subject further, inasmuch as a detailed coverage cannot be attempted in the present connection, the following brief bibliography is offered:

1. *Capitalization, a Book on Corporation Finance*, by W. H. Lyon. 1912. Houghton Mifflin Co., Boston. Pp. 84, 104, 170.
2. *Railroads, Finance and Organization*, by W. Z. Ripley. 1915. Longmans, Green & Co., New York. Pp. 90–96. Voorhis & Co., New York. Pp. 367–373.
3. *New York Corporations*, by F. White. 1915. Baker, Voorhis & Co., New York. Pp. 367–373.
4. *Financing of Public Service Corporations*, by M. B. Ignatius. 1918. The Ronald Press Co., New York. Pp. 76, 78–83.
5. *Financing an Enterprise*, by H. R. Conyngton. Volume 2, 1921. The Ronald Press Co., New York. Pp. 385–400.
6. *Journal of Accountancy:*
   October, 1919: pp. 248–257.
   November, 1919: pp. 385–394.
   May, 1924: pp. 321–348 }
   June, 1924: pp. 420–431 } One article.
   July, 1924: pp. 31–41 }
7. *The Certified Public Accountant*, January, 1923: pp. 14–18, 24.
8. *Harvard Law Review:*
   March, 1909: pp. 319–338.
   June, 1913: pp. 729–731.
9. *American Bar Association Journal:*
   October, 1921: pp. 534–537.
   November, 1921: pp. 579–582.
   December, 1921: pp. 671–673.
10. *American Law Review:*
    May, 1921: pp. 438–445.
    May–June, 1922: pp. 321–344.

Profit and Loss Account. — The net profit figure of a business is the one, usually, above all others, in which the auditor will be, and the proprietor should be, vitally interested. The Profit and Loss account presents a summary of all of the income and expense accounts. As it should be used, it is merely a means for closing these accounts at the end of each period — the connecting link between the nominal and the real groups. Every item of expense or of income should be posted directly to some expense or income account, and at the end of each fiscal period these elements are brought together, in the summary account

of Profit and Loss. The balance in the latter, representing net profit (or net loss) is closed into Surplus or into the respective capital accounts, as the case may be.

Although a Balance Sheet audit proper contemplates only the verification of Balance Sheet items, frequently, the profit and loss result must bear the auditor's certification as well. Hence, in addition to the work outlined as representing a Balance Sheet audit attack, it is usual for the auditor to analyze many of the nominal accounts, and to check or test as the circumstances seem to require.

In order to prepare an intelligent Profit and Loss Statement, the auditor must be familiar with the legal and economic phases of the income and expense accounts, and he must have the ability to express the transactions in statement form, in an intelligent manner. This seems to imply ability to analyze the nominal accounts and to set out the results so that the proper information is conveyed to the client in the best possible form.

The Federal Reserve Bulletin comments as follows:

> "The auditor should obtain the Profit and Loss Statement for three years, at least, including the period under audit, and after verifying them by comparison with the Ledger account, prepare a statement in comparative form. This comparison will furnish valuable information . . . as to past progress of the concern under audit.
>
> ". . . it would be impraticable in an ordinary Balance Sheet audit, and, at the same time, somewhat useless to make a detailed check of all the transactions entering into the composition of the Profit and Loss account. . . ."

Income Accounts. — Considerable has been presented above, at various points, relative to the income elements of a business. Nevertheless, since auditors seem prone to overlook the income producing elements or, at best, to pass over them most hurriedly — being satisfied with assuring themselves the expenses have been accounted for in order and that the assets are stated correctly — further comment on the nominal accounts' group cannot be out of order, particularly with reference to certain possible pitfalls and, also, to pick up certain loose ends not thus far accounted for. Although it may be the unusual, rather than the usual, to check in detail all transactions entering into the composition of the Profit and Loss account, certain matters should

be kept in mind the better to determine what shall, and what shall not, be done.

A clear separation should be made between operation and non-operation profits; a merging of the two prevents an intelligent comparison period by period and, for a given period, it is impossible to tell whether the business is on a profit basis or otherwise without first making a more or less bothersome analysis. Again, it is possible to have too much income reported as well as too little; at times a detection hereof may occur through studying the relationship of the Balance Sheet accounts to the income accounts. But where the bookkeeper is clever enough to recognize this possibility and, as a result, so adjusts his General Books that the suggested relationships appear in order, a detection by the above simple means will fail; it is necessary for the auditor to go much deeper. If the income accounts are examined carefully, analyzed month by month for the audited period, and comparisons then made against prior periods month by month, the trouble may be located.

It is important, for example, to study closely the possibility of sales inflation. This may occur, briefly, as under:

1. Certain shipments made just subsequent to the close of the period audited may be considered as sales of the audited period. This may be discovered by inspecting the shipping records, or by analyzing the inventory or production, or both. If shipping records are not adequate, teamsters' reports, railroad records, etc., may be utilized in this connection.
2. Sales may be inflated through the padding of accounts receivable. The proper circularization of customers' balances as of the last day of the audit period should uncover this inflation.

In a trading concern, the sales (or shipments made) should be the result (in quantities) of the sum of the beginning inventory and purchases less the ending inventory. The same idea in a manufacturing business is that sales (in quantities) should equal the sum of the beginning inventory of finished product and production less the ending inventory of finished product. This method seems too detailed to use, except where absolutely necessary to satisfy the auditor. In a first audit, it should be ascertained that sales at the beginning of the period were

recorded in accord with shipment dates, this being accomplished by comparing the shipping record with the billed invoices.

3. Cash sales may be inflated by considering receipts from accounts receivable as cash sales, and adjusting the resulting discrepancy in the following month by increasing the then accounts receivable. The discovery of the above may happen in more than one way: by inspecting the cash sales slips; by checking the Cash Book receipts against deposits and circularizing customers; by examining the correspondence of the last month audited for letters of transmittal, etc.

Further, in order to satisfy himself against sales inflation, the auditor may check the orders against sales, and satisfy himself as to old orders on hand unfilled. In this connection, it may be necessary, at times, to check against the salesmen's order books — as where the original orders are not available. A statement of orders unfilled, analyzed by months in which shipment is presumed to be made, may be interesting reading as part of an auditor's report; if prepared, a comparison should be made with former periods, the better to determine the business outlook of the enterprise.

As a matter of fact, the complete procedure as suggested above has been presented previously in connection with other parts of the work; hence, it is seen to serve a double purpose. In the current connection, it is usually unnecessary to resort to the full procedure suggested but, under suspicious circumstances, it may be absolutely necessary.

In the matter of returned sales, the question arises at this point as to whether gross sales is before or after the returns are deducted. Where returns are first deducted, the reason seems to be to maintain no real sale has been made of the goods returned; hence, they cannot be considered as part of sales. Although this practice is encountered frequently, even in large companies, it seems subject to criticism. The deduction of returns from the figure representing gross sales seems the more efficient practice. The size of the returns is an index of efficiency or inefficiency in filling orders, shipping exact goods called for, shipping within reasonable time, quality of goods and packing of goods. At times the returns are of considerable size, and

relate mostly to sales made in the former period; if so, a misleading figure results should the deduction be made from current sales without explanation. Where a perpetual inventory is in operation, it is possible to deduct from gross sales profit lost on sales returned, rather than to deduct the entire amount of the returns. Since the goods go back into stock, the stock account is charged for the value at which taken up; the accounts receivable are credited for the full amount involved and the difference between the two amounts is charged as a lost profit item. In some cases, it is possible to separate returns as between the current period and the past period and book accordingly, those relating to the past period being charged against Surplus account. The idea seems theoretically correct, but the practical application appears at fault; the analysis must be made by machine, which cannot always be done and, again, the value of comparisons of returns period by period is lost since a considerable portion in each period is buried in Surplus account.

Allowances to customers for trade discounts, freight out, and price reductions should not be forgotten. Freight prepaid on customers' shipments and freight deducted by customers on shipments delivered to them are treated by some as deductions from sales and by others as selling expenses. In any event, a separation should be made from freight paid on incoming goods or materials since the latter increases the inventory figure.

The Federal Reserve Bulletin suggestions on sales follow:

"Whenever it is possible, the quantities sold should be reconciled with the inventory on hand at the beginning of the period, plus the production, or purchases, during the period, less the inventory on hand at the end of the period.

"Where a good cost and accounting system is in force, the sales records will very probably be in good shape, but nevertheless, the auditor should satisfy himself from the shipping records that the sales books were closed on the last day of the fiscal year, and that no goods shipped after that date are included in the transactions.

"When an audit is made for the first time, the auditor should satisfy himself that the sales at the beginning of the period were recorded in accordance with the dates of shipments. Such verifications can be made conveniently by a direct comparison of the shipping memoranda with the invoices billed.

"Allowances to customers for trade discounts, outward freights, reductions in prices, etc., should be deducted from the sales in the Profit

and Loss account, as the amount of the net sales is the only figure of interest. . . .

"The future bookings at the close of the fiscal year should be looked into, as a comparison of orders on hand with corresponding periods of other years furnishes . . . an idea of the concern's business outlook."

Sundry matters connected with the consideration of income are summarized as under:

1. In a departmentalized business, departmental results are desirable since it is valuable information to learn which departments are producing a profit and which a loss.
2. Profits from the sale of fixed assets should be set out separately; they do not relate to operation and, in some states, it may be necessary to consider them eventually as capital surplus so they will not be distributed as dividends.
3. Profit on partly completed contracts presents a problem that should be given the utmost care and consideration by the auditor. In general, the treatment may be shown as under:
   a. General work in process:
      1. Where manufactured for the open market, no profit should be taken.
      2. Where manufactured under a legally enforcible contract, the inventory may be taken up at cost plus a conservative share of profit; however, in general, it seems better not to consider the profit element.

   b. Long-time contracts. If the work has been nearly finished, no real criticism seems possible for taking up a portion of the profit. But where necessary to do otherwise, the possibility of future loss should be reserved against.

Expense Accounts. — Dependent upon the accounting system in operation, these may be either simple or difficult to audit. If the records kept are in bad shape, any method of audit attempted will be unsatisfactory to all parties; the auditor should govern his report content accordingly. Basically, two methods of entry are encountered:

1. Expense analysis by means of a voucher system. Hereunder, if the analysis is thorough and the bills are attached properly to voucher jackets, the expense accounts' examination should be relatively a simple matter.

2. Expense accounts are debited from sundry records. Hereunder, if the bills are filed alphabetically, considerable trouble may be experienced in making the audit of this portion of the work.

Under the voucher system of entry, the expense analysis is found either upon the face of the Voucher Record, or upon the analysis sheets underlying it — but one column appearing on the Register for each major class of expense. The examination of vouchers, testing of extensions, distributions, etc., have been covered sufficiently in earlier chapters, it is believed, so that further comment at this point, other than that offered below, seems unnecessary.

In general, it is believed that exhaustive tests are sufficient on this portion of the work, rather than covering the reviewed period in detail. Further, to summarize the vouching procedure, the following is offered:

1. Charge correct?
2. Distribution approved?
3. Prices and extensions checked?
4. Check against records of receiving department.
5. Check voucher distribution against the Register distribution.
6. Secure official comment upon doubtful items.
7. List missing vouchers where value is of fair amount.
8. Mark voucher against possible second-time use.
9. Vouch canceled checks against vouchers and Register.
10. Names of creditors on vouchers, bills, and checks should be the same.
11. Scrutinize purchase discount entries in connection with Cash Book.
12. Test petty cash vouchers.
13. Foot Voucher Register in part or completely.
14. Check all postings to General Ledger.
15. Prepare list of all unpaid vouchers and check against control.
16. Scrutinize all adjusting entries affecting Vouchers Payable account.

Under a non-voucher system, the payment of bills is not usually tied into a system of filing the bills, the filing generally being

done alphabetically. Hereunder, the general procedure may be as follows:

1. Arrange all bills by payment dates.
2. Inspect various records holding original account charges, comparing bills therewith as to vendor, amount, distribution, etc., and with payment made. The work hereunder may be done in a detailed manner, or it may be sufficient merely to check certain months completely.
3. Observe distribution of debits closely since usually in error to a considerable extent.
4. Check all General Ledger postings.
5. Compare expenses with same for prior periods to uncover irregularities.
6. Foot all records related to expenses and purchases and check footings to the General Ledger.
7. Analyze petty cash payments, and determine that they are accounted for properly.
8. Determine where improvements may be made in the system and use discretion in drawing attention thereto in report.

In checking out the totals of the various expense accounts, emphasis should be directed to credits therein to determine none have been made for the sale of capital assets and for other items which should not be found in the expense accounts.

Deferred and accrued expenses which should be absorbed periodically, as monthly, should be studied with the idea of having each current month absorb the correct amount thereof. In order that monthly operating statements may be prepared, and recommendations appear to be in order looking toward this, all expenses should be placed upon a monthly basis.

The transportation charges of freight and express should be given some attention, particularly as to the following points:

1. Possible overcharges by carrier. These may be frequent where an inadequate system of checking freight and express bills is in operation.
2. Approval as to rates and weight, a test check hereunder seeming sufficient.
3. Payments made by client on f.o.b. destination shipments should be deducted from the invoices received.
4. Freight prepaid by the other party should be examined to some extent (see above).

Payrolls covering the factory workmen should be scrutinized most carefully. Where wages are paid in cash — pay envelopes being used — the person who prepares the payroll never should fill the envelopes or hand them out to the employees. Further, a current payroll should be audited carefully before the force is paid thereunder; just what this comprehends depends upon the payroll system in force. On the one hand, as is usual in a large concern, a series of tests should prove sufficient; on the other hand, as is usual in a small business, it is necessary to make a detailed examination of all phases of the problem. Basically, the payroll will be compared with the time clock record; and the latter, in turn, may be checked against the labor tickets prepared in the factory. For further comment, reference may be made to payrolls as covered in an earlier chapter — that on Kinds of Audits.

All factory accounts having a relation to operation costs should be scrutinized and analyzed. Some of this undoubtedly will have been done in verifying the in process and finished product inventories; but there is a connection of these accounts also with the factory accounting system in use, to determine the adequacy or inadequacy thereof.

In examining the selling expense accounts, the auditor should be guided partially, at least, by the contracts existing with the salesmen, particularly where these contracts specify the kinds of allowable items. Further, the basis of the salesmen's commission and bonus payments should be understood clearly. A clear understanding of the above factors should permit of intelligent interpretation and analysis being made. The reports rendered by the salesmen should be tested to a considerable extent, these being then checked against the vouchers and payments. The item of mileage at times may run into large sums; if so, the unused amount should be reported as an advance upon the Balance Sheet. Used mileage should check out against distances traveled as reported by the salesmen in connection with the schedules prescribed for them, say, semimonthly. The expenses accrued as covered by reports on hand immediately after the close of the period audited should not be forgotten, as well as those at the beginning of the period which belong to the prior one.

Advertising expense at times is deferrable, as where a special campaign has been ordered or where the advertising applies to a season subsequent to the close of the audited period. On the whole, the auditor should be most conservative in the amount of advertising expense deferred, leaning toward the practice of charging out as much as possible. Catalogue advertising may be handled upon the basis of inventory values; catalogue cost is charged to an inventory account which is reduced as advertising expense is charged with current mailings and old catalogues.

Office payrolls should carry an official's approval, and all salary changes should be authorized properly. Tests should be made of comparing canceled salary checks against the payrolls. The entire office payroll system should be examined in the light of the safeguards in existence and those apparently to be desired. Where every office employee is known to the manager, the latter's approval of each payroll seems sufficient; where the condition encountered is otherwise, it may be desirable for the auditor to prepare the payrolls and then request each department manager to approve his particular one. Those who prepare the payrolls ought to have no access to the records kept showing the names of those on the payroll.

The administration and general expenses, exclusive of salaries (already commented upon), should be analyzed so that comparisons may be made by kinds against previous periods. The vouchers hereunder should be tested at least. The accruals therefor at the end of the period should not be forgotten, as well as those booked at the beginning of the period but belonging to prior periods. It is incumbent upon the auditor to ascertain that all legitimate expenses have been taken up, but that those subject to criticism are eliminated; this may occur in connection with the account of Professional Services.

The Interest Expense account may be checked out at the time the underlying liabilities are examined. In connection with the verification of this account, it may be advisable to schedulize the interest charges on each obligation, arising during the period, the total of which schedule should agree with the account on the Ledger; inability to secure this agreement usually means that either the interest accrued or the interest adjustments between periods has not been considered. Interest on accounts

payable past due, on proprietors' or officers' loans to the concern, and on the possible sundry unpaid liens, should be looked into.

Expenses of an extraordinary nature, having no relation to operation must be entered in the Profit and Loss Statement after the net profits from operation have been stated; some of these will be charged off as expense of the current period, whereas others represent a surplus adjustment. In connection herewith, it must be determined that the entire amount has been accounted for, and that nothing has been manipulated to show more operating profit than rightly should be set out. All vouchers or payments related to expenses of this nature must be scrutinized carefully, and all unpaid liabilities resulting must be given careful consideration. In any event, the facts uncovered should guide the auditor's policy hereunder, rather than the arguments or contentions advanced by the client.

By having determined exactly what was included in the expense accounts, it is an easy matter to make a segregation which is usable when preparing the Profit and Loss Statement.

Agreements in existence between managers or other employees covering extra compensation as a percentage on the gross sales or net earnings should be scrutinized to discover the proper method to be followed in arriving at such a division of profits. In a corporation, it is usual to find minutes covering these agreements. Another difficulty hereunder apparently is due to the contract vagueness as to whether such amount shall be considered as an expense or as a division of profits.

The Federal Reserve Bulletin offers the following suggestions on some of the topics commented upon above:

Cost of Sales

"The inventory at the beginning of the period, plus purchases during the period, less inventory at the end of the period, gives the cost of sales. In a manufacturing concern the factory cost of production takes the place of purchases. These items will have already been verified in auditing the Balance Sheet, but nevertheless care should be taken to see that this heading has not been made a dumping ground for charges which would be more properly embraced under the heading of special charges. The composition of the items entering into the cost of sales should be traced in totals into the cost Ledgers or accounts.

Gross Profit on Sales

"This is obtained by deducting the cost of sales from the net sales. The ratio of gross profit to net sales should be calculated and compared.

Selling, General and Administrative Expenses

"Under these general headings should be set down the expenses itemized to correspond with the titles of the Ledger accounts kept in each division. In checking the totals of each account with the statement for the period under audit, special attention to credits in these accounts should be given to see that none have been made for the sale of capital assets and for other items which should not appear in expense accounts. The percentages of the totals of each division and of the aggregate total to net sales should be calculated for each year for comparison.

Net Profit on Sales

"This is obtained by deducting the aggregate total of the selling, general and administrative expenses from the gross profit on sales, and shows the net earnings of the concern on its real business. Ratio to sales should be calculated for each year for comparison.

Other Income

"Under this heading is embraced any income that may be derived from sources outside of sales, such as income from investments, interest, discounts, etc. Schedules should be prepared of each item, and the auditor should satisfy himself of their accuracy and of the propriety of including them as income.

Deductions from Income

"Under this heading are grouped such items as interest on bonded debt, interest on notes payable, etc. The same procedure of verification as in the case of other income should be followed.

Net Income — Profit and Loss

"Adding other income to gross income and deducting deductions from income gives the net income or profit and loss for the period, which is the amount that should be carried to the Surplus account.

Surplus Additions and Deductions

"Items of unusual or extraordinary profit which do not belong strictly to the period under audit, or cannot be said to be the legitimate result of the ordinary transactions of the concern, should be entered here and verified with the Surplus account. Similarly, deductions should be treated. Also dividends declared should be entered in the Surplus account and as an item under this caption, inasmuch as it is the usual

custom to declare dividends 'from net earnings and surplus.' After adding special credits to and deducting special charges from the net income we have the total profit and loss for the whole period from all sources which, added to the surplus balance at the beginning of the period, gives us the surplus at the end of the period, which should agree with the surplus as stated on the Balance Sheet."

Journal. — The General Journal is used primarily to record opening, closing, and adjusting entries, and entries of a special nature for which no separate special Journal is used. All postings should be checked to the respective Ledger accounts, and it should be ascertained that each entry is in order; this latter comprehends having each entry supported by the proper official's authorization or by a Journal Voucher properly approved. Vouching the Journal, in its way, is as important as vouching cash, since entries may have been made in error, intentionally or otherwise, which have a material bearing on the accounts. Entries covering depreciation, bad debt reserves, sundry other reserves, interest on capital, accruals, stock issues, etc., are met with frequently upon the Journal. Each Journal entry composed of more than one debit (or credit) should be footed to determine that the total debit does equal the total credit thereof; where the Journal columns are footed throughout the book, it seems desirable for the auditor to prove such footings.

Conclusion. — The comments presented above have been designed to cover varying representative situations encountered in concerns of different size. In large enterprises, a detailed procedure may be absolutely impracticable, and the existing internal checks should make it unnecessary. In these instances, only tests can be made, as a rule, but the auditor should be prepared at all times to justify his departure from a complete plan by showing that what is to be accomplished under the given set of circumstances has been effected adequately by the work actually done. And in this connection it would seem that the auditor ought to do at least what has been advocated by the Bulletin referred to above and as much more as the situation justifies.

Although the above comments represent an attempt to introduce the reader and student to the practice of auditing, it is hoped that a fairly complete procedure underlies what has been

presented inasmuch as a number of actual audit plans have been referred to in compiling the principles offered. It should be remembered, however, that only experience will permit an auditor to determine accurately what shall compose an adequate procedure; no amount of theoretical contact can accomplish this completely.

Some auditors refuse all assistance, in a clerical capacity, by a member of the client's staff who may be assigned to aid. It is believed that any extensive clerical work well might be performed for the auditor by one of the younger clerks on the client's staff; on the one hand, such practice will eliminate undue expense to a certain degree, or will permit the auditor a day or so more in which to cogitate upon his conclusions to the end that his report may be of marked constructive help which might not be the case otherwise due to the pressure of time. In most cases, it is believed that the clerk selected for this work will appreciate the chance given him, and will consider it as an opportunity.

As a final point, experience has demonstrated the existence of a possible chance for error in passing assets as correct upon the Balance Sheet when, in fact, a portion of them are not in actual existence in the concern under scrutiny. Vouching, checking, and footing may not uncover such a situation regardless of how carefully the work is done. Only by the exercise of every intelligence and by constant vigilance can reasonable safety be assured clients.

CHAPTER XIII

THE AUDIT REPORT

Closing the Audit. — Before the auditor leaves the office in which the audit work has been done, he should make certain that all matters have been covered properly so that his report may be prepared without further access to the books and records or the asking of questions. In general, this comprehends making a final scrutiny of the Trial Balance, analyses, summaries, audit plan, notations of matters to be looked into or questioned, and adjusting entries prepared. Under ordinary conditions, the necessary adjusting entry should be made just as soon as the particular matter requiring it has been completed; at times, for lack of information, it may be impossible to do so until later after the requisite knowledge has been obtained.

Next, all books and papers that have been in use and are still out of order should be returned in a condition as nearly similar as possible to that in which they were received. Emphasis was made at an earlier time relative to neatness. If an auditor does not deem it advisable to rearrange the papers in an orderly manner himself, a little tact on his part usually will secure assistance from one of the office clerks.

Further, the courtesies of a gentlemanly leave-taking should not be forgotten. Incidentally, a cheerful comment of appreciation for the attentions that have been extended the auditor and his assistants is in order.

Some difference of opinion seems to exist as to whether the auditor's report should be written in the office where the work was performed or in the auditor's office. It would seem that at times the former practice could be followed to marked advantage, as where a firm member (the auditor's superior) has been in close contact with the assignment, and the privacy of the auditor is secured by having his work desk so placed that interference by any of the client's staff is not usual; again, on an out-of-town assignment where it is usual for the auditor to labor two or

three evenings a week, a portion of such time may be used with profit in drafting at least certain parts of the report, inasmuch as, undoubtedly, a better report will result because of the availability of the client's records. It is believed, however, that the practice of writing the report in the auditor's office is the one usually encountered.

Working Paper Index. — Prior to submitting a set of working papers for criticism by his principal, the auditor should have them indexed properly. Early in this book comment was made on arranging working papers during an engagement and thereafter; but a second contact with the point seems not to be out of place, particularly due to the importance thereof. Briefly, the following plans are illustrative further:

1. The index is prepared upon a separate sheet which is placed on top of the working papers. The order of arrangement thereafter depends upon circumstances and the particular plan followed by the office to which the auditor is attached. Undoubtedly, the second sheet will contain a list of check marks used, but beyond that considerable variation is found. Some may have the audit plan and statements next, whereas others may have these papers at the end of the set. The subsequent sheets may be arranged according to the submitted Trial Balance, in the order in which the accounts were attacked, in the order in which the adjusted accounts appear on the control sheet, or in some other manner; undoubtedly, the control sheet arrangement is as popular as any and has considerable merit.
2. Many auditors index the working papers from the control sheet, using the extreme left-hand column for the working sheet folios, or a column near the middle of the sheet. This second plan can be recommended without hesitation, using the left-hand column for the working sheet numbers. An experienced auditor on an assignment of small or moderate size, being thoroughly familiar with the work, frequently will have no formal audit plan, unless required to prepare one, doing his planning and keeping his record of progress on the face of his underlying control working sheet. In such event, a definite set of checkmarks is used, being entered as necessary, next to the index numbers to control the work in hand; a glance at the marks already made will inform him just what has been done and what remains unfinished.

Criticism of Working Papers. — Assuming that the auditor has returned to his office, it seems that the next step contemplates a review of the working papers prepared, this to be done by the principal. The latter should be most careful and painstaking in his scrutiny thereof.

This review, briefly, relates to reading the facts presented by the monetary amounts, and determining whether or not they are justified by the existing conditions. These latter may be segregated about as under:

1. The facts of the past as set out in previous audit reports and statements of former periods
2. The relationship of various factors to other factors — as those uncovered by the application of the gross profit test, percentage to sales or cost, turnover, etc.
3. The peculiar conditions encountered in the concern under audit, and in the industry in which such business is a part

Perhaps it is safe to say that the Balance Sheet figures first are examined. And in this connection, the following questions are offered as illustrative of the line of attack:

1. In what particulars has the audit changed the Balance Sheet?
2. What reasons exist for assuming the cash correct as adjusted?
3. Have petty cash slips been segregated properly as between past and current period?
4. Have inventory adjustments been taken up properly in the related accounts, as Purchases, etc.?
5. Are the notes receivable on hand and under discount properly accounted for?
6. Have the accounts receivable been adjusted so that the amount represents probable convertibility in the normal course of events?
7. What is represented by certain peculiar items and accounts shown?
8. Etc., etc.

A scrutiny of the information found upon the various working papers should produce the correct answers to questions of this type. If not, it seems safe to say that whoever prepared them

should be taken to task more or less severely as circumstances justify. Whatever the senior carries in his mind covering his expected treatment of a certain item, rather than placing his handling thereof on paper, is of no use to the person criticizing the papers. A careful review on his part of the papers prepared is in order before he hands them over to the examiner, so that what the figures are presumed to represent may be clearly stated.

As the review proceeds, certain changes undoubtedly will appear advisable. Notes on these are made so that each may be taken up in turn for inclusion in the adjustments if necessary, upon the control sheet, and in the adjusted statements; perhaps certain matters should be taken up with the client directly and separately before everything may be assumed as in order. This last possibility arises frequently where current practice encountered differs from that generally followed by like concerns in that industry; if a heavy notes receivable item is the practice rather than open accounts, but the opposite is encountered, there must be a reason, correct or incorrect under the circumstances.

Report Components. — The most careful attention should be given to the preparation of the audit report, inasmuch as this usually is all that the client receives for the fee charged for making the audit; further, not only is there a story to tell clearly in a minimum number of words, but the report indicates to the client the standards of professional neatness, accuracy, and thought which the auditor has established as his rule and guide. The auditor in charge of the case undoubtedly prepares first a draft in rough form, after which this draft is corrected and a rough typewritten copy made; next, when final corrections have been entered thereon, the last typing occurs.

Basically, it seems that a report may be divided into the following portions, in the order of their location therein:

1. Letter of submittal — prepared last
2. Certificate of audit — prepared next to last
3. Comments — prepared second in order
4. Statements — prepared first

Statements. — Since these usually are prepared first, it seems logical to discuss them at this point. Undoubtedly, they are prepared in rough form before the final draft is made. Statements may be divided into two or three classes; at present, it seems that the third class is gaining recognition:

1. Exhibits
2. Schedules
3. Graphs or charts

Statements usually are prepared in rough form in the original instance on analysis paper, journal paper, and on coördinate paper, these three kinds of paper following the three classes of statements suggested above. They are made up from the control working sheet, and the various account analyses plus the adjusting entries prepared. When the rough form of a statement is ready for typing, the constructor should make certain that it has been prepared exactly as he desires the copies to be struck off, since it may be assumed, in general, that the typist will copy only what the rough form shows without thought of whether the copy is right or otherwise. A desirable rule seems to be that no abbreviations are to be used upon a statement; the auditor may know what an abbreviation stands for, whereas the client or other possible statement reader may not be able to interpret it.

Exhibits are the basic statements around which the report is built and concerning which it is submitted. For report purposes, exhibits are indicated by letters, as a rule, the exhibit letter being placed at the bottom of the sheet, at the top thereof near the extreme right, or at the top in the center of the sheet. The typical exhibits usually are:

1. Trading concern:
   a. Exhibit A — Balance Sheet
   b. Exhibit B — Profit and Loss Statement
2. Manufacturing business:
   a. Exhibit A — Balance Sheet
   b. Exhibit B — Profit and Loss Statement
   c. Exhibit C — Statement of Cost of Manufacture and Cost of Manufactured Product Sold

Frequently, it is desirable to prepare a Statement of Cash Receipts and Disbursements and a Statement of Application of

Funds; the latter, ofttimes is included as part of the audit comments. Again, the Balance Sheet, Profit and Loss Statement, and Statement of Cost of Manufacture and Cost of Manufactured Product Sold may be in comparative form. Other statements may be advisable under particular assignments.

Exhibits are supported by schedules, these latter being statements subsidiary to the related exhibits; they present the detail or analysis of items found in the latter. On a given case, whether a statement is basic or subsidiary governs in determining whether it is an exhibit or a schedule. For report purposes, schedules usually are numbered, the numbers being placed thereon in a position similar to that used on the exhibits for showing the exhibit letter. If a certain item is shown on the Balance Sheet, and it is desired, also, to set out its components, then a schedule will be used, for example: List of Accounts Receivable; this might be labeled Exhibit A, Schedule 1. Frequently, the Profit and Loss Statement contains so many debit items of a class, if all are included therein on its face, that it is desirable to set out the components of that class of items in a schedule, for example: Schedule Showing Details of Selling Expenses; this might be marked Exhibit B, Schedule 1. The schedulizing of profit and loss items by classes must be done, at times, in order not to have the basic statement spread itself beyond the confines of one sheet of paper.

Graphs or charts are statements in diagrammatic form, presented in this manner presumably because it is assumed that diagrams are understood easier than the same information would be where set out in figures and percentages. They relate, primarily, to showing comparisons and progress.

In constructing an exhibit or schedule, painstaking care should be observed in the matter of technique. The title heading of a statement — which describes it — should be accurate; a Balance Sheet, for example, is as of a certain date and not for an elapsed period, whereas a Profit and Loss Statement covers an elapsed period and is not as of a certain date. Again, if a concern is known as The Jones Manufacturing Company, accuracy of description cannot tolerate a main heading of Jones Manufacturing Company; if the registered name of a firm is Brown Bros., the abbreviated word should be used in the heading.

A title heading should describe exactly what the contents of the statement represent and nothing else. If two or more Profit and Loss Statements are presented in comparative form, the main heading should designate such fact. Again, regardless of the statement title, the latter should be both clear and brief.

The title heading of a statement consists of three parts, as a rule, each being allocated to a separate line, or to but two lines; for example:

The Jones Manufacturing Company
Balance Sheet
December 31, 1923

The Jones Manufacturing Company
Balance Sheet — December 31, 1923

Each primary heading or caption in a statement should describe the particular class of items included thereunder, as: Assets, Liabilities, Liabilities and Capital, Capital and Surplus (pertaining to the Balance Sheet) as the particular case may require. The general comment above concerning the title headings applies with equal force in the present connection.

The side captions in a statement are used to group items of the same class, so that a subtotal may be obtained for extension into the last column at the right, it being assumed that such total is of marked informative worth to the statement reader; for example: Current Assets, Fixed Assets, etc.

Each statement account caption represented by figures in a column to the right thereof should describe clearly the item involved. Usually, the account names as found in the Ledger are sufficiently accurate as they stand; nevertheless, if the auditor believes the description of an item is not sufficiently accurate under the circumstances, he should not hesitate to revamp it.

Report rulings usually are made with red ink, although it would seem that black ink presents just as neat an appearance as any other. At any rate, regardless of color, uniformity and neatness are essential.

Graphs and Charts. — Unless a person is accustomed to figures and works with them most of the time, he is apt to experience considerable difficulty in ascertaining the significance

of a set found in a submitted statement. The recognition of this fact by progressive practitioners undoubtedly is responsible for the growing interest given to graphic charts, and to their inclusion in audit reports. A graphic picture may register relationships and comparisons upon the mind of a statement reader which would be lost entirely if nothing but figure information is available; further, under certain conditions, such a graph even may point out things to the auditor that would be missed under any other method of set-up.

Report Comments. — The comments in an audit report have certain definite purposes among which the following are illustrative:

1. To emphasize certain matters which might be overlooked by a mere reading of the statements
2. To permit the statements to be prepared in a form both clear and brief, sundry explanations being dropped from them but remaining available for the reader
3. To permit details to be presented relative to an item where they are not deemed sufficient in number to require the making of a schedule
4. To acquaint the reader with exactly what the auditor has done and what he has not done in his verification of certain audit matters
5. To criticize tactfully and constructively
6. To suggest changes which will eliminate a cause for criticism
7. To recommend certain accounting procedures for adoption, provided such recommendation is desired by the client

Audit comments should be written in a most tactful manner, so that they will not offend. Abruptness and harshness do not seem to be the only means available for making a client see the truth as the auditor has interpreted it; drawing one's attention somewhat indirectly to a certain existing situation is more apt to retain that person's goodwill than to make a verbal direct hit. Positive statements should never be made by an auditor unless he is willing to go on legal record to prove them.

The personal touch should not be used in writing comments, if it can be avoided; it seems preferable to adopt, as much as can be, an impersonal attitude or form. In commenting upon

particular persons within the concern, it seems advisable, also, to refer to them by title rather than by name — as the Treasurer, rather than Mr. Smith.

Whether the comments occupy but part of a page or a number of pages, it would seem that their order of arrangement should follow that of the location of the items upon the statements. Some auditors seem to favor commenting more or less fully on most, if not all, of the items found in the statements submitted, whereas others seem inclined merely to write on what they consider are important things assuming, undoubtedly, that the client is not particularly interested in the detail procedures utilized in making the audit. As a matter of fact, it seems that all the comments made by certain auditors are located in the letter of submittal, and relate to matters illustrated as under:

1. Type of audit made
2. Amount of profit
3. Manner in which profit was made
4. Application of profit. In this connection, it may be desirable to include a Statement of Fund Application.
5. Present financial condition

The style of writing employed, seemingly of general adoption, is to use simple words, short sentences, and avoid technical expressions. A literary style does not appear desirable; severe simplicity of expression which a person not versed in accounting theory will comprehend seems all that is to be desired. In order to secure this, some firms have on file a series of form paragraphs and phrases which the report writer is expected to employ; even though these may represent good style and eliminate the possibility of hackneyed phrases or non-understandable ones, it seems that their undesirability far outweighs the possible benefits that may accrue from their use. In general, one audit is not like another, and it seems to be decidedly difficult to have on hand "boiler plate" (a term used by journalists) to fit the circumstances of each assignment; further, the report writer may find it impossible to express precisely what he wishes to say, in terms predetermined for him.

Certificate of Audit. — This has the object of expressing the opinion of an outside experienced person as to the accuracy of

the facts submitted in the report prepared by him. Such certificate may be placed on a separate sheet, it may be included at the bottom of the Balance Sheet, or it may be part of the letter. Dependent upon position, a slight variation in wording is necessary, in addition to whatever variations may be required as to the certificate content.

The usual points covered by a certificate may be illustrated as under:

1. A statement that the accounts have been audited for a particular period of time
2. Particular limitations:
   a. Of a positive character — as showing briefly what was done
   b. Of a negative character — as showing briefly what was not done
3. The phrase "We (or I) Hereby Certify"
4. That the statements:
   a. Set forth the true financial condition and operation results, or
   b. Are correct
5. Signature and professional title
6. Place and date

Regardless of certificate content, it seems that the auditor should assume a certain amount of responsibility; hence, the limitations or qualifications contained therein ought to be as few as possible under the circumstances. If the certificate merely indicates the statements are correct, or agree with the books, undoubtedly considerable criticism is in order; the statements may be correct, and they may agree with the books in every item, yet the books may be incorrect. On the other hand, if the certificate certifies that "the Balance Sheet and Profit and Loss Statement are correct and, in the auditor's opinion, subject to accompanying comments, reflect the true financial condition and operation results respectively" upon a certain date, something definite has been said, and certain determinable responsibility has been assumed.

An illustrative short form of certificate follows:

THE JONES MANUFACTURING COMPANY
CERTIFICATE OF AUDIT

We have audited the books and accounts of The Jones Manufacturing Company for the year ended December 31, 1923, and

WE HEREBY CERTIFY that the herein submitted Balance Sheet and Statement of Profit and Loss are correct and, in our opinion, subject to the accompanying comments, reflect the true financial condition and operation results respectively on such date.

WORK & DOMUCH,
CERTIFIED PUBLIC ACCOUNTANTS

Syracuse, New York,
February 8, 1924.

An illustrative long form of certificate is shown as under:

THE DOUGLASS COMPANY
CERTIFICATE

We have audited the books and accounts of The Douglass Company for the year ended June 30, 1924; we have verified the cash and notes receivable; the inventory certified to by officials of the company has been checked by us as to prices, footings and extensions; we have tested the accounts receivable by checking the Customers' Ledgers against the controlling accounts and believe the reserve against collection losses is adequate; it is believed the other reserves provided are sufficient for their respective purposes; and, subject to Plant and Building valuation based upon the appraisal by XY & Company

WE HEREBY CERTIFY that, in our opinion, the accompanying statements are correct.

A. & B.
ACCOUNTANTS & AUDITORS

New York, August 9, 1924.

Undoubtedly, for reasons already advanced, and for others which might be indicated, the short form wording is far more desirable than that of the long form. The form of certificate suggested in the Federal Reserve Bulletin is as follows:

"The Balance Sheet and Certificate should be connected with the accounts in such a way as to ensure that they shall be used only conjointly. This rule applies also to any report or memorandum containing any reservations as to the auditor's responsibility; any qualification as to the accounts, or any reference to facts materially affecting the financial position of the concern.

"The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner.

"If the auditor is satisfied that his audit has been complete and conforms to the general instructions of the Federal Reserve Board, and that the Balance Sheet and Profit and Loss Statement are correct, or that any minor qualifications are fully covered by the footnotes on the Balance Sheet, the following form is proper:

"I have audited the accounts of Blank & Co. for the period from .... to .... and I certify that the above Balance Sheet and Statement of Profit and Loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at .... and the results of its operations for the period.

("Signed A.B.C.")

Letter of Submittal. — This is merely a letter typed upon the business stationery of the auditor, presenting the report to the client. Since it is the first sheet of the report proper, it may be assumed, in general, as the logical place on which to set forth an index of the report contents; infrequently, this index may occupy a separate sheet either preceding or following the letter.

Form of Report. — The audit report should be typewritten or printed on paper uniform in size and of excellent quality. The auditor's name may be engraved or lithographed on the first sheet, and all sheets used may carry a private watermark. Single or double sheets may be used, preference seemingly being in favor of single sheets because of the less amount of time consumed should it be necessary to retype one or more of them, due to mistakes. If the report form of statements is used, single sheets seem to work well; should it be found that a comparative form of statement cannot be placed on the width of a single sheet, because of the narrowness of the latter, it is possible to use the opposite sides of two leaves to equal the equivalent of one large sheet, the two page faces being placed against each other, and the binding being made at the left side.

Reports may be bound at the side or at the top; on the one hand, a report bound at the side is opened and read like a book whereas, on the other hand, a report bound across the top is opened and read after the manner of handling a legal document. The binding should not be made until after the typed report has

been checked carefully as to copying, figure accuracy, and figure harmony; and, also, before binding, the report should be paged, the pages arranged in order, a blank sheet placed at the front and back, and the whole collection of sheets re-edged so that all of the edges are even. Report covers are heavy paper or leather; if paper, the punch holes usually are three in number, and the fastening is made with ribbon, corded braid, or metal fasteners. Infrequently, a report is fastened in the manner followed by many attorneys in binding a last will and testament; the report is sewed with a narrow ribbon, the final knot being made inside in such a position that the loose ends may be stuck to the certificate sheet, to the left of the signature, with a wax wafer carrying a seal impression. The report cover may be so folded and punched that all of the fastenings are not seen on the outside.

Regardless of the care which may be used in preparing a report, general practice seems to favor an appearance that is rich but quiet.

The number of copies prepared of a report may vary with circumstances. It would seem that a sufficient number of carbon copies should be made so that one may be used for purposes of comparing, calling and checking back the contents, one for the auditor's files, and one extra over the first number of copies to be sent out for purposes of emergency calling for an additional copy. At times, it may be necessary to submit only originals, carbons not being desirable; if so, the entire report must be re-typed as many times as are requisite, unless it is printed. In general, the first carbon copy is utilized in the work of comparing, proving, and checking figures, and in checking references, this being rubber-stamped on the first page so that spaces are provided in which may be entered the names or initials of the employees who did the work. This first carbon copy is placed on top of each typed set as the latter is delivered from the typing room to the employees for checking purposes, the rubber-stamped space containing the initials of the typist who did the work.

All in all, the above comments on the audit report should be considered as illustrative only; many variations in form and make-up are possible. Because of this fact, it is deemed inadvisable to present herein a so-called complete report since, of necessity, its composition will depend upon the particular assign-

(Name of Enterprise)
BALANCE SHEET
December 31, 19—

Exhibit "A"

ASSETS

CASH:			
Cash on Hand — currency and coin		$¢	
Cash in Bank		$¢	$¢
NOTES & ACCOUNTS RECEIVABLE:			
Notes Receivable of Customers on Hand (not past due)		$¢	
Notes Receivable Discounted or Sold with Indorsement or Guaranty		$¢	
Accounts Receivable of Customers (not past due)		$¢	
Notes Receivable of Customers, past due (cash value $....)		$¢	
Accounts Receivable of Customers, past due (cash value $....)		$¢	
		$¢	
Less:			
Provisions for Bad Debts	$¢		
Provisions for Discounts, Freights, Allowances, etc.	$¢	$¢	$¢
INVENTORIES:			
Raw Material on Hand		$¢	
Goods in Process		$¢	
Uncompleted Contracts	$¢		
Less: Payments on Account Thereof	$¢	$¢	
Finished Goods on Hand		$¢	$¢
OTHER QUICK ASSETS:			
. . . .		$¢	
. . . .		$¢	$¢
TOTAL QUICK ASSETS			$¢
SECURITIES:			
Securities Readily Marketable and Salable, without impairing the business		$¢	
Notes Given by Officers, Stockholders, or Employees		$¢	
Accounts Due from Officers, Stockholders, or Employees		$¢	$¢
TOTAL CURRENT ASSETS			$¢
FIXED ASSETS:			
Land Used for Plant		$¢	
Buildings Used for Plant		$¢	
Machinery		$¢	
Tools and Plant Equipment		$¢	
Patterns and Drawings		$¢	
Office Furniture and Fixtures		$¢	
Other Fixed Assets, if any		$¢	
		$¢	
Less: Reserves for Depreciation		$¢	
TOTAL FIXED ASSETS			$¢
DEFERRED CHARGES:			
. . . .			$¢
OTHER ASSETS:			
. . . .			$¢
TOTAL ASSETS			$¢

LIABILITIES

BILLS, NOTES, & ACCOUNTS PAYABLE:			
Unsecured Bills and Notes:			
Acceptances Made for Merchandise or Raw Material Purchased		$¢	
Notes Given for Merchandise or Raw Material Purchased		$¢	
Notes Given to Banks for Money Borrowed		$¢	
Notes Sold through Brokers		$¢	
Notes Given for Machinery, Additions to Plant, etc.		$¢	
Notes Due to Stockholders, Officers, or Employees		$¢	$¢
Unsecured Accounts:			
Accounts Payable for Purchases (not yet due)		$¢	
Accounts Payable for Purchases (past due)		$¢	
Accounts Payable to Stockholders, Officers, or Employees		$¢	$¢
Secured Liabilities:			
Notes Receivable Discounted or Sold with Indorsement or Guaranty (contra)		$¢	
Customers' Accounts Discounted or Assigned (contra)		$¢	
Obligations Secured by Liens on Inventories		$¢	
Obligations Secured by Securities Deposited as Collateral		$¢	$¢
Accrued Liabilities:			
. . . .			$¢
OTHER CURRENT LIABILITIES:			
. . . .		$¢	
. . . .		$¢	$¢
TOTAL CURRENT LIABILITIES			$¢
FIXED LIABILITIES:			
Mortgage on Plant (due date....)		$¢	
Mortgage on Other Real Estate (due date....)		$¢	
Chattel Mortgage on Machinery or Equipment (due date....)		$¢	
Bonded Debt (due date....)		$¢	
Other Fixed Liabilities		$¢	$¢
TOTAL LIABILITIES			$¢
NET WORTH:			
If a Corporation:			
Preferred Stock (less stock in treasury)		$¢	
Common Stock (less stock in treasury)		$¢	
Surplus and Undivided Profits (see Exhibit "B")		$¢	
		$¢	
Less:			
Book Value of Goodwill	$¢		
Deficit	$¢	$¢	$¢
If an Individual or Partnership:			
Capital	$¢		
Undistributed Profits or Deficit (see Exhibit "B")	$¢		$¢
TOTAL			$¢

(Name of Enterprise) *Exhibit "B"*

COMPARATIVE STATEMENT OF PROFIT AND LOSS FOR THREE YEARS ENDED......19—

	19—	*19—*	*19—*
Gross Sales	$¢	$¢	$¢
Less: Outward Freight, Allowances, and Returns	$¢	$¢	$¢
Net Sales	$¢	$¢	$¢
Inventory, Beginning of Year	$¢	$¢	$¢
Purchases, Net	$¢	$¢	$¢
	$¢	$¢	$¢
Less: Inventory, End of Year	$¢	$¢	$¢
Cost of Sales	$¢	$¢	$¢
Gross Profit on Sales	$¢	$¢	$¢
Selling Expenses (itemized to correspond to Ledger accounts kept)	$¢	$¢	$¢
Total Selling Expense	$¢	$¢	$¢
General Expenses (itemized to correspond to Ledger accounts kept)	$¢	$¢	$¢
Total General Expense	$¢	$¢	$¢
Administrative Expenses (itemized to correspond to Ledger accounts kept)	$¢	$¢	$¢
Total Administrative Expense	$¢	$¢	$¢
Total Expenses	$¢	$¢	$¢
Net Profit on Sales	$¢	$¢	$¢
Other Income:			
Income from Investments	$¢	$¢	$¢
Interest on Notes Receivable, etc.	$¢	$¢	$¢
	$¢	$¢	$¢
Gross Income	$¢	$¢	$¢
Deductions from Income:			
Interest on Bonded Debt	$¢	$¢	$¢
Interest on Notes Payable	$¢	$¢	$¢
	$¢	$¢	$¢
Net Income — Profit & Loss	$¢	$¢	$¢
Add: Special Credits to Profit and Loss	$¢	$¢	$¢
	$¢	$¢	$¢
Deduct: Special Charges to Profit and Loss	$¢	$¢	$¢
Profit & Loss for Period	$¢	$¢	$¢
Surplus Beginning of Period	$¢	$¢	$¢
	$¢	$¢	$¢
Dividends Paid	$¢	$¢	$¢
Surplus End of Period (see Exhibit "A")	$¢	$¢	$¢

ment covered. Some valuable practice is possible in certain phases of report writing in connection with a portion of the quiz material for this chapter, and on the report to be prepared as part of the solution to the problem composing the final chapter of this book.

Suggested Basic Statements. — The Federal Reserve Bulletin suggests certain forms for the Balance Sheet and Profit and Loss Statement, particularly where their submission is for the purpose of securing credit; these are shown on pages 240, 241, with but slight changes in the original composition:

Conclusion. — Before including anything in a report, the auditor should consider carefully the purpose and value thereof to the client. At times, a voluminous report may be desirable, even necessary; but, in general, a certain odium results which will reflect adversely against the auditor. Pages and pages of detail unnecessary in presenting the ideas which the auditor has in mind, and not conveying anything new to the client or that which he desires, are absolutely useless; such a report has all the earmarks of weakness and lack of crystallized purpose.

Briefly, a report should have some definite object — some specific message — and this should be presented in the briefest manner possible consistent with completeness and clarity. One successful merchant criticized a report covering his various stores in terms about as follows: "Two hundred pages of hot air; not one thing is contained in it which I did not know all about long ago. If the gist of the good points herein had been boiled down to some ten pages, I would feel more inclined to pay the bill than I do at present." This report was prepared by what may be considered as one of the large firms.

CHAPTER XIV

THE BUSINESS BUDGET

Introduction. — As a result of the Budget and Accounting Act, providing budgetary procedure for the administration of the U. S. Government, new impetus is evident in budgeting. In fact, the present-day auditor frequently is confronted with the task of either preparing such a budget or advising and instructing relative thereto. Because of the great current interest in this subject, and because of the general usefulness of the budget to trading and manufacturing businesses, the present volume would be somewhat incomplete were the principles underlying the mechanism omitted therefrom.

Budgeting Defined. — Each business should plan in advance as to what should be accomplished in respect of future net profit, rather than operate blindly by accumulating no information other than that which relates to actual happenings. This planning in advance for net profit, at least as applied to a business establishment, seems to be the true definition of " budgeting."

If the budgetary idea is carried to its logical conclusion, one must give due and careful consideration to all of the functions, factors, and elements of the particular establishment under review. Since the fundamental purposes of keeping accounts are to set forth clearly and accurately financial condition and net profit progress or securement, and since these purposes are reflected in the Balance Sheet and Profit and Loss Statement respectively, it seems that however curtailed or elaborate the budget report may be, it would not be complete unless there are included:

1. An Estimated Balance Sheet, to show result expectation at the end of the period next to be covered; and
2. An estimated Profit and Loss Statement, to point out how such result is expected to be accomplished

It is the purpose of the business budget to coördinate the various functions of a business so that as a rounded-out organism and cohesive unit the struggle for the net profit goal may be attempted. It is the purpose of the marketing function, for example, to secure buyers for the largest quantities of goods at a minimum of distribution cost. Again, the production function desires to produce those products which it can handle the most easily so that the resultant outcoming quantities will be the greatest possible and the cost thereof the lowest. Further, the financing function is selfishly interested in the production and sale of products which will cause the business coffers to fill quickly with the minimum expenditure of effort. A scrutiny of the idiosyncrasies of each of the above three prominent business functions shows that each, by itself, has nothing in common with each of the others.

Large sales at a low sales cost do not necessarily guaranty securing a satisfactory net profit; they may eventually turn an actual profit into a future loss. Volume production, also, if beyond a unit cost which the market will absorb cannot result in a net profit conclusion. And if nothing is kept in mind beyond a quick money return, it may be necessary, in order to secure this, to reduce the profit rate to such a point that a loss actually results for the operating period. It is the duty of the executive, therefore, to erase these conflicting interests and replace them by those which are so coördinated that the business machinery will turn harmoniously and strive as a mechanism in complete adjustment toward the goal of net profit. It is from the budget that the executive secures a clear view of the whole problem in perspective, so that therefrom he may judge of the dovetailing of the various plans outlined for future operative conduct.

Business Thermometers and Barometers. — A discussion of a possible procedure to be followed in preparing a budget is of small value unless one first comprehends certain of the principles that must be understood in order to form intelligently an estimate of what is to be accomplished during the next period. These principles are those which relate to business forecasting.

It is not the present purpose to attempt to cover this subject completely. But by pointing out some of the usual barometers

or thermometers, and commenting briefly upon their usefulness, lines of thought may be suggested for further study.

The Business Cycle. — Business conditions always are moving upward or downward — favorably or unfavorably. At certain times, activity is intense, after which a gradual letting up or falling away takes place which eventually causes activity to be replaced by sluggishness; and from a stagnation a quickening of movement gradually occurs so that a recovery takes place until a period of prosperity is again in evidence. This up-and-down swing, which is said to assume the appearance of a circle, is known as the "business cycle."

Periods of prosperity and periods of depression follow each other year in and year out, some long and others short. But it is a fairly difficult matter to determine just how soon the arrival of one or the other may be expected and how long it will remain. The only means yet available for outguessing the inevitable, is to watch and study the trend and movement of certain business factors, and utilize the results obtained in formulating an estimate of the conditions to be expected in the near future.

The relationship of the above to budget preparation and criticism is a close one. A business man may plan for an extensive sales program, but if he has not informed himself clearly upon possible demand, and the factors in evidence which tend to increase or decrease such demand, the formulated plan is most apt to cause disaster if carried out. Everyone who thinks a moment, will agree that the market must be anticipated successfully in order to secure the largest amount of profit consistent with existing circumstances; the closer supply comes to demand, the greater will be the resulting profit.

In principle, the determination of the balance between supply and demand is a simple matter, but in practice, since modern commerce is complex — its various factors being woven and intermingled so that they affect each other in varying degrees — the facts of supply and demand present a most confused appearance, and the problem of balance is a difficult one to solve. One industry is so dependent upon some other or others, that should a break occur in this chain of dependencies, the effect thereof is most difficult to anticipate; hence, the anticipation of future demand at any particular stage is fraught with difficulty.

Barometric Factors. — Commercial activity may be separated into five particular divisions or groups of effort:

1. Growing and raising. This division is related intimately to all products of agriculture and the farm.
2. Extraction. This group concerns such activities as mining, quarrying, etc.
3. Conversion. Hereunder are grouped such activities as melting, refining, building, manufacturing, etc.
4. Distribution. This concerns the moving of products to the user — transport, storage, wholesaling, jobbing, retailing.
5. Financing. Banks, investment houses, and similar activities are engaged in financing.

A study of activity within each of these divisions will do much to enable one to foretell what conditions are approaching. It is frequently necessary, also, to consider the activity of certain lines of endeavor which do not fall within the scope of the above main movements of commercial products, although these are more or less incidental.

The study of these main channels of commercial movement, so essentially necessary as a means by which to judge present and future conditions, is aided by a consideration of numerous economic barometers. Price and production of such leading commodities as wheat, corn, cotton, wool, sugar, coffee, leather, iron and steel, rubber, coal, copper, and paper furnish valuable barometric information. Wholesale prices of such products as foodstuffs, clothing, house furnishings, building materials, and chemicals also are of value in this connection. Furthermore, barometers of general application must not be overlooked, as bank clearings, tonnage movement or railroads, stock exchange conditions, business failures, new businesses, and employment conditions.

In order to study the above barometric factors intelligently, one is aided to a marked degree by directing the attention to some one or more of the various economic forecasting services available to the public. Each of these attempts to group the numerous factors into a logical classification but, owing to their number and diversity, considerable variation is noticed. Nevertheless, the information offered is decidedly useful as well as being of an interesting nature.

Whatever the set of groupings may be, one notices the existence of a certain similarity of factors as between them and, hence, it may be said that these are the ones generally accepted as satisfactory indicators of business trend:

1. Production
2. Price
3. Finance

Agricultural production is looked upon as a good indicator of near future conditions. If crops are good, there is evidence of coming activity, whereas poor crops are the apparent forerunner of dullness. These deductions are so generally accepted that the Government issues a crop forecast in September upon the basis of which the fall and winter activity is presumed to be adequately estimated; in the same way, the foretelling of summer and fall conditions is supposed to be possible from the Government's spring report on winter wheat. Industrial production, on the other hand, is said to be a better present index than future forecast. Present prosperity may be due to heavy production if this is backed up by a real demand. In order to secure a check upon this latter angle — that of real demand — production statistics for iron and steel are studied in connection with the amount of unfilled orders of the U. S. Steel Corporation; a drop in orders at a time when production is increasing is taken to indicate the coming of an unfavorable situation.

Conditions of employment have a current significance rather than a future one. A drop in wages coupled with increasing unemployment points toward depression; when wages are high and unemployment is not serious, times are prosperous. But if the upward trend of wages is too rapid, one is put on notice that a period of prosperity is on the wane; under conditions of this kind, strikes appear. When building operations are the most active, the pendulum is on the upward swing, but as prices climb this activity drops off. During a period of depression, building activity is presumed to be fairly active. Building operations, however, are thermometers rather than barometers, indicating present status rather than future possibilities.

The second fundamental indicator of business trend — price — is generally looked upon as showing the present situation in an

able manner. Prosperity is said to be linked with rising prices.

The third generally accepted barometer — finance — is viewed in the light of indicating the development of certain conditions. Credit conditions must be favorable if commercial activity is on the rise, since the demand for loans increases. But as loans increase, reserves decrease, and when reserves are low, the granting of loans must be curtailed. The restricting of loans presages the approach of a period of liquidation. On the other hand, if interest rates are low, and reserves are strong, and other signs are not unfavorable, prosperity is assumed to be near. The amount of bank clearings is a factor to be studied in the determination of present conditions.

The general trend of business may be seen through the general trend of the stock market, if one qualifies his opinion by the possibility that certain stocks may be manipulated for reasons which have no connection with business conditions generally. When the stock market assumes an attitude of sluggishness, it may be presumed that conditions throughout the country probably will be sluggish as well; and when the opposite state strikes the market, the near future probably will be entirely satisfactory. In other words, if the prices of a number of industrials are charted, over a period of time a reasonably accurate basis is said to be provided for estimating the future; in fact, certain economists are inclined toward the belief that the stock market furnishes one of the best general barometers available.

Statistical data are available for specific lines of business endeavor. Perhaps as regards a particular line of business statistics as to commodities on hand are valuable for study purposes. If the curve is going upward beyond the normal, the danger of a period of intense competition is near; if the curve is bending downward below normal, and assuming that a normal demand for product will remain, prices may be expected to rise.

Likewise, governmental regulations relative to industries and commodities should not be overlooked. The taxation of earnings affects business conditions, and tariff changes affect competition with foreign products. Also, in relation to foreign competition in this country, and to the possibility of success in foreign markets, such matters as foreign exchange, exports, and imports furnish valuable information.

A study of the various barometers mentioned above permits the business executive to secure an approximately accurate basis from which to gauge future sales. Since the question of what the future sales will approximate in amount must be decided satisfactorily before the remaining portions of the business budget can be prepared, the importance of business barometers in budgeting exceeds that of anything else. When a business sells its product to the general public, it is most necessary to predict accurately the sales volume for short periods in advance; this accuracy cannot be secured without an adequate knowledge of forecasting being possessed either by the person whose task it is to determine the sales quota or by the one whose duty it is to O.K. the quota as set.

Budget Use. — If the sales manager, for example, decides to increase the sales for September to $37,000.00, whereas during August they amounted to $29,000.00, it is impossible to determine offhand if the increase decided upon is justified by the facts. He may believe that the $8,000.00 sales increase should bring a proportionate increase in net profit; this may not be true. The preparation of a budget, showing estimates of various departments for September, when corrected and O.K.'d may show that the new plan is grossly in error. For example, assume the following Profit and Loss Statement prepared from budget figures:

ESTIMATED PROFIT AND LOSS STATEMENT (BUDGET BASIS)
MONTH OF SEPTEMBER, 1924

SALES:		
A Goods — 200 units @ $20	4,000.00	
B Goods — 1,500 units @ 22	33,000.00	37,000.00
COST OF GOODS SOLD:		
Material:		
A Goods — 200 @ $6	1,200.00	
B Goods — 1,500 @ 8	12,000.00	
Direct Labor:		
A Goods — 200 @ $6	1,200.00	
B Goods — 1,500 @ 8	12,000.00	
Overhead:		
A Goods — 200 @ $3	600.00	
B Goods — 1,500 @ 4	6,000.00	33,000.00
GROSS PROFIT		4,000.00
EXPENSES (Departmentalized)		2,500.00
ESTIMATED NET PROFIT		1,500.00

ACTUAL PROFIT AND LOSS STATEMENT
MONTH OF AUGUST, 1924

SALES:		
A Goods — 350 units @ $20	7,000.00	
B Goods — 1,000 units @ 22	22,000.00	29,000.00
COST OF GOODS SOLD:		
Material:		
A Goods — 350 @ $6	2,100.00	
B Goods — 1,000 @ 8	8,000.00	
Direct Labor:		
A Goods — 350 @ $6	2,100.00	
B Goods — 1,000 @ 8	8,000.00	
Overhead:		
A Goods — 350 @ $3	1,050.00	
B Goods — 1,000 @ 4	4,000.00	25,250.00
GROSS PROFIT		3,750.00
EXPENSES (Departmentalized)		2,000.00
NET PROFIT		1,750.00

As a matter of fact, the increased sales, as planned, will result in a decreased net profit, a situation not desired. B Goods, which are to be pushed more emphatically, carry a smaller margin of gross profit than A Goods:

	A Goods $		B Goods $	
Sales		20		22
Cost:				
Material	6		8	
Direct Labor	6		8	
Overhead	3	15	4	20
Gross Profit		5		2

Now, if this business manufactured a large number of varied products, and the executive had no means of knowing approximately the accurate cost, it is seen readily that a serious situation may develop quickly without any intimation thereof being available beforehand. The budget, in other words, will help greatly in crystallizing intelligent judgment.

It should be appreciated, however, that a budget does not show actual facts, and that actual performance cannot be expected to agree therewith exactly. It is a working basis, and the more

skilled the various executives become in preparing their particular estimates for budget inclusion, the nearer will the estimated figures approximate the actual ones. When the latter situation is reached, executive decisions may be made in the light of the budget figures.

Budget Procedure. — It is incumbent upon each department to prepare its own budget. When each such is completed, the department head should scrutinize, revamp, and approve, after which the various portions submitted to him are redrafted into the plan of that particular function which then is passed along to the executive in general control of all activities. At this point of rest, the various functional plans are gone over, after which the final complete plan is prepared and approved. Subsequent to this, nothing remains to be done except to prepare the Estimated Balance Sheet and Profit and Loss Statement. The chief executive then receives the completed report for study, revision, and approval.

As mentioned previously, the sales estimate must be prepared prior to all other portions of the budget since so much of the remaining parts are dependent thereon. The sales estimate to a large extent, for example, governs the production plan and the latter, in turn, predominates the materials estimate. Considerable information should be available for each department relative to the actual facts of the previous period, particularly as to expenses.

The actual figures of the past form the foundation of the budget preparation, since these figures are revised as the circumstances seem to demand, dependent upon one's knowledge of forecasting. The material prices may remain constant during the new period and, again, they may not; the more complicated the product ingredients are, the more difficult it is to anticipate what will be their purchase prices. Further, the element of spoiled work in the factory has a direct effect upon direct material costs. The direct labor costs must be analyzed in detail before intelligent decision thereon can be reached. Certain influencing factors are internal, and some are not; a cutting down of idle time may lessen labor cost, as will perhaps the installation of efficiency methods, whereas matters occurring outside of the plant premises may cause either a drop or a rise in future labor costs.

The fixed overhead charges must be studied separately from those which are changeable. Fixed overhead frequently remains constant when production is increased; again, the increasing effect may be noticed. Fluctuating overhead probably increases with the increase in production, yet undoubtedly not proportionately therewith.

It is important that the budget period is of the correct length, but this depends upon the particular business and upon the conditions peculiar to such business. The turnover may govern the length of the budget period, but whatever its length is there should be a meshing with the length of accounting periods. If the budget periods do not correlate with the accounting periods, actual progress as to result securement cannot be determined. If a business is seasonal, a busy and dull season should be included; further, its length should be sufficient to permit of a complete cycle of both sales and production activities. Sometimes, the budget period will be short and, again, it will be long; if a business is subject to frequent and sudden changes, the period should be as short as possible. Where a yearly budget is prepared, monthly budgets are advisable, these tying into the yearly one, so that as time passes, revisions may be made as circumstances require, but without obscuring the year's plan.

In order to insure the completeness of a budget, since the value of an incomplete one is questionable, one should study closely the chart of accounts in use in the business, assuming that the latter is entirely adequate. If the chart of accounts has been properly constructed, the latter will cover in a satisfactory manner the functional divisions of the concern, as financing, production, marketing, etc., and the departments related to each of these as well, regardless of what may be the particular differentiation involved.

From the above, it is evident that mere clerical ability is not sufficient to enable a person to prepare a satisfactory budget estimate. Experienced judgment is absolutely essential, and yet this cannot be acquired or developed except through numerous contacts with the problems of budget construction. The more budget work is attempted, the more experience is secured; first attempts are most apt to seem entirely unsatisfactory as to results secured.

Budget Form. — There is no standard display that the form of the budget should take. The primary requisite is that each portion or division should be as uniform as possible, as to detailed subdivisions, with each other portion or division. Each function will report its probable payroll and expenses; some will report new assets needed or desired. The marketing function will compile statistics on orders taken, unfilled, and shipped, in addition to reporting its probabilities as to payroll and expenses. The producing function must submit information on materials and supplies to be used, on the material, labor, and overhead components of cost of sales, and on the material, labor, and overhead makeup of manufactured product estimated for the period. There must be a Balance Sheet as of the close of the past period, and a Cash Statement (Estimated) showing opening balance, probable receipts by classes, and probable disbursements by classes. There must also be an Estimated Balance Sheet and Profit and Loss Statement for the new period, the Balance Sheet preferably being in comparative form.

The question next arises as to how to prepare the Estimated Balance Sheet and Profit and Loss Statement so that these will intermesh with each other as under double-entry. The method that may be adopted to secure this is the same as that used by auditors to build up the accounts for a period, after which a Trial Balance is drawn and statements prepared. In other words, the Balance Sheet as of the close of the last period (actual) is the starting point; this may be spread upon working paper with sufficient space between each item to permit of charges and credits to the accounts covering estimated future transactions. Then the budgetary information found in the various budget schedules is spread upon the working sheet by Journal entries, being set up against this opening Balance Sheet (actual). The Trial Balance follows as a matter of course, after which the estimated statements may be prepared.

CHAPTER XV

THE FIRST AUDIT. AN ILLUSTRATIVE STUDY PROBLEM

Introduction. — The theoretical training of students who expect to enter into the accounting profession is absolutely essential; yet those trained only in theory are far from having had a course which makes possible their general acceptance into professional ranks in a junior capacity. The study of any or all of the available texts upon Auditing never will make a student thereof a proficient auditor.

Recognition of the above has resulted in the present attempt to prepare a problem which reflects some of the atmosphere, at least, of an actual audit. If the work in the course to date has been carried out conscientiously, the student should have, prior to commencing the solution of this problem, a fair idea of principles and of forms of working sheets and schedules.

Although it cannot be said, in truth, that it is possible for laboratory practice to supplant the practical contact secured as a member of the staff of a recognized accounting office, it is the hope that this exercise, prepared upon the basis of situations which have arisen in practice, and of ideas secured from a careful scrutiny of many C.P.A. questions and problems in auditing, will be of considerable help, particularly in that it attempts:

1. To present a correlated review of the major portion of the principles already covered
2. To enable the student to secure a representative set of working papers to which he may refer when occasion demands
3. To illustrate a possible audit procedure which covers more of the common situations calling for solution than an average assignment

If any discrepancies are uncovered in the progress of the work, it is believed that most of these, if not all, were placed in the

problem with malice aforethought to test the students' powers of analysis and correlation.

In order to avoid dates which eventually are too far in the past, the situations developed do not go back beyond a two-year period of activity; therefore note the following:

1. The current incomplete year in which the audit is made is designated as 19x.
2. The current year just closed at the end of which the audited Balance Sheet is to be prepared is designated as 19a.
3. The year just prior to the one just closed is designated as 19aa. As of the time when the student works on this problem, the actual dates may be inserted in the problem and on the working papers; for example, assuming the audit is made as of the year 1924, then:

   19x is 1924
   19a is 1923 (year of audit, at end of which Balance Sheet prepared)
   19aa is 1922

WORK & DOMUCH
PUBLIC ACCOUNTANTS — AUDITORS

Received at Office
DATE......12/28/a ENGAGEMENT MEMO NO.....1608

CLIENT: Hancock Manufacturing Company CLIENT NO. 1019
ADDRESS: 1920 Water Street, City
TELEPHONE: W–8–6463
CONTACT: J. B. Hancock, President *with* I. Work
ADDRESS REPORT TO: J. B. Hancock, President
NATURE OF BUSINESS: Manufacturer of Office Appliances
NATURE OF ASSIGNMENT: Audit for year ended 12/31/a
TO BEGIN: 1/7/x
TIME ESTIMATE: Four–five weeks
STAFF REQUIREMENTS: 1 Semi-senior
RATES: Usual per diem
REPORT EXPECTED: 3/1/x
COMMENTS: 1. First audit
2. Examine Balance Sheet accounts from date of organization, January 1,19aa (2 years)
3. Probable possible dividend on common stock

First Steps. — Prior to 1/7/x:

1. Use remaining portion of week available in which to prepare tentative plans.
2. Secure letter of introduction.
3. Secure time reports, working paper, firm business cards, etc.
4. Secure general instructions from firm partner; note the following: "communicate at once with office when in doubt. Office of the Hancock Manufacturing Company opens at 8:30 A.M.; report each day at that time and do not leave until office closes in the afternoon (except for lunch) unless to report back for instructions."

Morning of 1/7/x:

1. Present self at company office sharp at 8:30 A.M.
2. Introduction to President, Mr. Hancock
3. Conversation with Mr. Hancock. Notes taken:
   a. Company incorporated January 1, 19aa
   b. Business seems satisfactory but of late Mr. Hancock obsessed with notion the accounts have not been kept as they should. Suspicious of manager's assistant
   c. Books kept by double-entry
   d. Monthly Trial Balances, but out late
   e. President and Treasurer: J. B. Hancock; Secretary: O. Jones; Factory Manager: H. Brown — Directors
   f. Office Manager and Head Bookkeeper: D. Henning (age 63); in employ from beginning. Honesty unquestioned.
   g. Assistant to Office Manager: B. Stewart (28); unmarried; in employ one year; be careful
   h. Cashier and Stenographer: Anna Smith (39); in employ from beginning
   i. Books never audited; system developed by both managers
   j. Vouchers, invoices, and records supposedly in order to date.
   k. Examine as necessary, but do not go back into operations beyond 19a; accept operation therefor as per books; books not closed for 19a
   l. Desire expressed by auditor to count cash and to secure copy of Trial Balance at 12/31/a
4. Introduction to various persons whose names appear above

5. A glance at Trial Balance disclosed four accounts of present import: Cash, Petty Cash, Notes and Acceptances Receivable, Investments
6. Agreeable place secured in which to work

Cash. — Count of cash on hand (in presence of B. Stewart, cashier) at 8 : 55 A.M., January 7, 19x, produced the following:

I. O. U.'s:			
Cashier, dated 12/4 a (no approval)			$ 30.00
CHECKS:			
Able & Sand	1/5/x	$110.00	
Black & White	1/5/x	142.00	
Crosby & Company	1/3/x	73.00	
Dunlop & Smith	1/2/x	8.50	
Eberle & Jones	1/12/x	55.00	388.50
O. B. Sauter	10/27/a		
Marked with bank stamp N.S.F.			96.15
CURRENCY:			
$20 bills	5	$100.00	
10 "	9	90.00	
5 "	10	50.00	
2 "	8	16.00	
1 "	19	19.00	
Half-dollars	21	10.50	
Quarters	17	4.25	
Dimes	25 # 16	4.10	
Nickels	25 # 19	2.20	
Pennies	12	.12	296.17
		Total	$810.82

Currency on hand on morning of 1/7/x, resulted from cash sales of 1/5/x. Checks on hand on 1/7/x, received from customers; entered in due course in Cash Book. Deposits are made on the morning of the next banking day succeeding day of receipt. Check of Eberle & Jones, dated 1/12/x, for $55.00 (see above) was received on 12/28/a. O. B. Sauter has left the city and cannot be located. When check returned by bank, protest charges of $1.75 were incurred, and were taken up on Cash Book in November as a debit to Sales.

Petty Cash. — Count of petty cash on hand (in presence of Anna Smith, petty cashier) at 9 : 10 A.M., January 7, 19x, developed:

BILLS:			
$10	3	$30.00	
5	5	25.00	
2	5	10.00	
1	24	24.00	$89.00
SILVER, ETC.:			
$0.50	11	$ 5.50	
.25	21	5.25	
.10	25 # 25	5.00	
.05	25 # 25 # 20	3.50	
.01	12	.12	19.37
STAMPS:			
.10	4	$ .40	
.06	5	.30	
.04	9	.36	
.02	25	.50	
.01	80	.80	2.36
Check of O. Jones, dated 1/2/x, on the F. T. & Deposit Co.			40.00

VOUCHERS — All approved by Manager D. Henning:

Nos. 823 of	1/2/x	$10.00	
24	1/2/x	1.30	
25	1/2/x	.90	
26	1/3/x	.45	
27	1/3/x	8.19	
28	1/5/x	2.20	
29	1/5/x	1.17	$ 24.21
		Total	$174.94

Sundry Cash Facts. — Footing the Cash Book for the first four days in January (excluding 1/1/x) produced:

Net Debit Total	$21,052.32
Net Credit Total	4,312.18

A signed order was secured from Mr. Hancock on the City Bank Trust Company to honor all inquiries concerning balances carried and the financial affairs of the Hancock Manufacturing Company. Pursuant to this order, the following was secured from the bank:

1. Bank statement for December, 19a
2. Certification that on January 5, 19x, at end of business day, the Hancock Manufacturing Company had on deposit $18,618.22, including interest of $30.04, credited on 12/31/a
3. Canceled checks accumulated to 1/5/x

The bank reconciliation as of 11/30/a was secured from B. Stewart.

On 12/18/a, a sight draft was drawn on the Office Supply Company of Utica, N.Y., for $1,010.20, this representing balance due from them. Draft was credited to Hancock Mfg. Co. by the City Bank Trust Company, collector, on 12/28/a.

On 12/28/a, a note signed by the Jones Equipment House, Auburn, N.Y., for $750.00, dated 10/3/a, and due 1/2/x, no interest, was sent to bank for collection.

A check from the Montreal Stationery Company, $110.00, of Montreal, Canada, was received on 1/4/x, being deposited by Company as of 1/5/x.

A comparison of the canceled checks returned against Cash Book entries, resulted in the following list of outstandings, as of 1/5/x:

Nos.	Date Issued	To Whom	Amount
8819	10/1/aa	C. L. Black	$ 82.40
18420	12/29/a	S. D. Hinge & Sons	102.75
18424	12/31/a	Bauer & Smith	310.18
18425	1/2/x	Syracuse Foundry	220.90
18427	1/3/x	L. M. Edwards	90.85
18428	1/4/x	Chair Hospital	6.88
18429	1/5/x	Saunders & Co.	201.10
		Total	$1,015.06

Check No. 8819 was found in the November reconciliation; all other outstandings thereon are cleared. C. L. Black was a salesman formerly in company employ. He left the office one evening subsequent to 10/1/aa, and failed to show up at any time thereafter; a registered letter sent some six months ago to his last known address was returned. Above facts confirmed by office manager, Mr. Henning.

A comparison of daily receipts and deposits per Cash Book for January, 19x, produced:

Date	Receipts	Deposits
2	$1,921.02	$ 814.19
3	1,486.65	1,920.72
4	1,768.25	1,486.15
5	684.67	1,658.05

Differences in the above result from exchange having been deducted by bank from face of each deposit, each latter being credited to company net. Exchange determined for December, 19a, was $5.40.

Notes Receivable. — These were examined, the following being on hand:

1. Solid Furniture Company, dated August 1, 19a, due February 1, 19x, interest at 6%, $946.00.
2. Tarbell & Bacon, dated August 1, 19a, due December 1, 19a, for $1,500.00, interest at 6%. Protested; protest charges $3.10, paid from petty cash, and charged to Salesmen's Salaries.
3. Jones & Sperry, dated December 1, 19a, due March 1, 19x, interest at 6%. Indorsed by president, Harlow Andrews. Amount, $1,800.00.

The following note was in the hands of the company attorney, J. B. Shawney, for purposes of suit for collection. Existence confirmed in writing by Mr. Shawney, who states: "Able & Bogg now in bankruptcy; at most 20% will be received on claim which was presented on 12/18/a to referee in due form.":

1. Able & Bogg, dated July 1, due October 1, 19a, interest at 5%, $892.50.

Investments. — An examination of the securities on hand plus other information thereon developed the following:

1. 20 shares common stock — Tillman Appliances Company, a local corporation (par $100.00). An analysis of the Investments account resulted in the following:

Debits:	50 shares purchased June 15, 19aa, @ 120		$6,000.00
Credits:	20 shares sold 12/30/aa, ex div. @ 125	$2,500.00	
10 shares sold 9/1/a, @ 100		1,000.00	
Balance covering stock investment			$2,500.00

A dividend of 6% was declared as of 12/1/aa, payable as of 12/31/aa, and received 1/10/a, at which time same credited to Dividends on Stock. Communication with Treasurer of Tillman Appliances Company substantiated the above. No further dividends declared or received thereon.

2. 10M B.L.T. Stores 1st Mtge 4's (par $1,000.00). Maturity 1935. Interest payment dates J — D. Interest coupons in order. Purchased on 11/21/aa @ 88 5/8. Total purchases at cost $9,051.39
Interest taken up as and when due.
3. 5M Salt City Motor Exchange, 1st Mtge 5's (par $1,000.00). Maturity 1940. Interest payment dates J — J. Interest coupons in order. Purchased 6/26/a @ 100. Total purchases cost $5,121.53
Interest taken up as and when due.

Bond valuations as on 12/31/a secured from local brokers:

1. B.L.T. — December 30, 19a, quoted @ 75
2. Salt City Motor Exchange — December 29, 19a, sales @ 101

Trial Balance — Minutes. — The trial Balance of the General Ledger as of December 31, 19a, is as under:

1	Real Estate & Buildings	$50,950.00
4	Machinery — Tools — Equipment	38,150.00
9	Auto Equipment	4,700.00
13	Sprinkler System	600.00
16	Furniture & Fixtures	2,086.00
20	Patents — Trademarks — Goodwill	2,565.50
25	Treasury Stock	5,050.00
27	Investments	16,672.92
30	Customers' Accounts	49,880.00
40	Notes & Acceptances Receivable	5,888.50
45	Purchases	107,326.50
62	Petty Cash	175.00
70	Cash	15,191.73
75	Labor	25,000.00
81	Fuel	5,400.00
84	Repairs — Machinery	2,500.00
87	Provision for Depreciation — Machinery	1,850.00
90	Taxes	1,145.00
93	Factory Expense & Supplies	9,821.00
95	Salesmen — Salaries & Expenses	5,000.00
99	Advertising	9,000.00
101	Office Salaries	12,500.00
104	Office Expense & Supplies	3,200.00
107	Provision for Depreciation — Furniture & Fixtures	424.00
111	Sales Discount	950.00
113	Interest	1,124.31
118	Insurance	947.04

Amount carried forward

120	Mortgage on Real Estate		$ 20,000.00
125	Creditors' Accounts		4,300.00
140	Notes Payable		11,589.35
150	Capital Stock		110,000.00
155	Sales		157,679.50
170	Raw Material Sales		8,000.00
178	Appreciation — Real Estate & Buildings		12,000.00
180	Interest Received		1,825.00
190	Surplus		53,597.15
		$378,991.00	$378,991.00

As a result of reading the Minutes, the following notes were made:

1. Authorized amount of capital stock: Preferred, $150,000.00 (1,500 shares @ $100.00); Common, $150,000.00 (1,500 shares @ $100.00).
2. January 10, 19aa: Moved and carried that negotiations be commenced by Hancock to close deal for purchase of property upon which to erect building for manufacturing, same to be paid for by 50 shares preferred and 50 shares common stock.
3. January 10, 19aa: Moved and carried that a patent on steel filing cabinet now owned by Hancock be purchased, price as entered upon the books not to exceed $2,000.00.
4. January 10, 19aa. Moved and carried that negotiations be concluded by Hancock to purchase property for sale adjoining piece agreed upon as indicated above. Price to be reasonable.
5. January 10, 19aa: Moved and carried that a vote of thanks and appreciation be extended Hancock for donation of 100 shares preferred capital stock to company to create a surplus.

Investigation of System. — A scrutiny of the office routine produces the following:

1. Office boy brings in the mail about 8:30 A.M.
2. Mail is opened by Stewart; then distributed:
   a. Order letters to Mr. Hancock
   b. Finance letters to Henning
   c. Checks, money orders, and cash kept by Stewart and entered by him in Cash Book
3. Anna Smith actually cashier only over petty cash

4. Hancock, Henning, and Miss Smith arrive between 8 : 30 — 9 : 00 A.M.
   - *a.* Orton Jones : Factory
   - *b.* Henning : General Ledger, correspondence, notes payable, general supervision of office. Assisted to large extent by Stewart
   - *c.* Miss Smith : Billing (in duplicate) totals being carried forward to end of month to get total sales. Duplicate bills are numbered consecutively, a new series of numbers being used each month. Frequently assisted by Stewart
   - *d.* Stewart : Accounts receivable and payable Ledgers. Postings made direct from duplicate bills to Customers Ledger

5. Petty cash :
   - *a.* Supplied by check as needed, to return fund to a round amount of $175.00
   - *b.* Stamps used freely, being purchased on order ; no check on issues
   - *c.* Petty cash vouchers cleared through Voucher Register

6. Payroll :
   - *a.* Prepared in factory under supervision of Jones
   - *b.* Envelopes :
     - i. Smith writes employee's name, number, amount
     - ii. Stewart places money in envelopes, and seals them
   - *c.* Check drawn for full amount ; overages returned to general cash

7. Books of original entry :
   - *a.* Journal
   - *b.* Voucher Register (Ledger accounts not dispensed with)
   - *c.* Purchase Returns Book
   - *d.* Sales Book
   - *e.* Sales Returns Book
   - *f.* Cash Book

8. Ledgers :
   - *a.* General
   - *b.* Customers
   - *c.* Creditors

Errors Uncovered in Routine Work on Cash Book. — The results hereunder discovered may be summarized as under :

1. Debit footing short $2,000.00
2. Credit footing over $1,000.00
3. False debits to Expense :
   - *a.* Factory Expense, $1,300.00
   - *b.* Advertising, $700.00
   - *c.* General Office, $350.00
   - *d.* Sales Discount, $650.00
4. Cash payments :
   - *a.* March 2, 19a : Accounts Payable overfooted $100.00
5. Cash Receipts :
   - *a.* October 17, 19a : Accounts Receivable overfooted $100.00

Errors Uncovered in Routine Work on Sales Record. — The Sales Book was proved and errors uncovered were summarized as :

1. Sales amounting to $1,000.00, chargeable to Accounts Receivable were not posted ; collected in full.

Errors Uncovered in Routine Work on Voucher Record and Invoices. —

1. Footings :
   - *a.* Accounts Payable underfooted, $10.00, on October 25, 19a.
   - *b.* Office Supplies column underfooted, $10.00, on November 3, 19a.
   - *c.* Total for November, 19a, $4,618.10, Dr. to Purchases as $4,681.10, and Cr. to Accounts Payable as same.
2. Vouching :
   - *a.* Invoice of Bonn & Co., January 9, 19a, $816.20, entered in V.R. as $816.20 ; paid by check No. 9302 as $861.20.
   - *b.* Invoice of Goode, Brant & Co., February 16, 19a, $714.28, entered in V. R. as $711.18 ; paid by check No. 9410 as $711.18.
   - *c.* Invoice of Butler, Street & Jones, April 24, 19a, of $82.16, entered in V. R. as $82.16 ; paid by check No. 9601 as $82.06.

d. Invoice of Spicer, Pegler & Co., April 28, 19a, for $118.92, entered as $181.92; paid by check No. 9680 as $118.92.

e. Invoice of Day & Munns, July 18, 19a, of $96.18, entered as $96.18; paid by check No. 11402 as $69.18.

3. Discount not deducted on invoices:

	Concern	Date	Amount	Terms	Paid
a.	Sweetzer & Jones	1/4	$300.00	2/10	1/12
b.	Ordway Stevens	2/10	116.20	1/30	3/6
c.	Paisley & Co.	2/28	212.40	2/10	3/7
d.	Sweeney-Smith	4/6	85.90	2/10	4/13
e.	Howard Co.	5/17	186.70	2/60	7/5
f.	T. E. Scott	7/9	96.00	2/10	7/12
g.	Olson & Co.	10/6	250.00	2/60	12/2

4. Distributions:

a. Ralston & Jerry, $201.60, page 82 of V. R. charged as Office Expense; should be advertising.

b. Carey & Taylor, $118.10, page 88 of V. R. charged as Factory Expense; should be Purchases.

c. Stover & Brown, $18.10, page 96 of V. R. charged to Office Expense as $8.10, whereas Cr. to Accounts Payable is $18.10.

d. Ellis & Gay Co., $19.40, page 102 of V. R. charged to Factory Expense as $29.40, whereas Cr. to Accounts Payable is $19.40; charge to be to Office Expense.

5. Postings to Ledger:

a. False debit found in Ledger of $20,000.00.

Errors Uncovered in Checking out General Journal. — 1. Entry of March 19, 19a was:

Dr. Notes Payable	410.65	
Cr. Accounts Payable		410.65

Explained in entry as representing a cancellation of above account and giving of note to replace same.

Notes Payable. — A summary of the account components (current items) produced the following:

1.	Debits:		
a.	Ochner & Black, March 19, 19a; J. 18; due 12/19/a; interest 5%		$ 410.65
b.	Butler & Scovill, October 16, 19aa; due 1/15/a		3,000.00
	Actual Total		$ 3,410.65
c.	Shortage uncovered in Dr. footing		3,000.00
	Total Dr. per Ledger		$ 410.65
2.	Credits:		
a.	C. B. Trust Co., dated 7/31/a, interest 6% payable at maturity; 1/31/x		$ 2,000.00
b.	C. B. Trust Co., dated 8/1/a, interest at 6% payable at maturity; due 2/1/x		3,000.00
c.	Citizens Bank, dated 8/1/a, due 3/1/x; interest at 6% payable at maturity		6,000.00
d.	Spencer Willis & Co., dated 12/1/a, due in 60 days; interest at 6% paid to maturity		1,000.00
	Actual Total and Cr. per Ledger		$12,000.00
e.	False credits uncovered above:		
	C. B. Trust Co.	$2.000.00	
	Citizens Bank	4,000.00	$ 6,000.00
	Total Cr. covered by original entries		$ 6,000.00
3.	Balance per Trial Balance		$11,589.35

Inventories. — These are summarized as under:

1.	Finished product	$21,000.00
2.	Goods in process	8,000.00
3.	Raw materials	10,000.00
4.	Fuel — 160 T. @ $1.25 (cost)	200.00
5.	Factory supplies (cost)	300.00
6.	Office supplies (estimated)	200.00

Inventory certificate secured covered the following:

1. Quantities of raw materials, supplies, fuel, goods in process:

a. Taken by actual count, weight, or measurement (except office)

b. Same taken as of 1/5/a

2. Valuations:

a.	Finished product:		
	At sales value, per list	$30,000.00	
	Less — 30%	9,000.00	$21,000.00
b.	Goods in process:		
	Direct labor and material	$7,000.00	
	Estimated overhead	1,000.00	8,000.00
c.	Raw materials:		
	Actual cost	$9,000.00	
	Plus increase in market, later on 12/31/a being $10,500.00	1,000.00	10,000.00

3. No information hereunder that any materials or supplies passed f.o.b. point in transit at 12/31/a.
4. Product billed, not shipped, has not been included.
5. No inclusion of goods on consignment.

An examination of the receiving tickets discloses:

1. Goods checked in on 12/29/a, $126.50; receiving ticket sent to office for entry on 1/2/x. Goods are glue, sandpaper, drawer handles, screws, and bolts.

Sales billed between 12/31/a, and 1/5/x, amounted to $445.00. $236.50 of this amount represents goods shipped prior to 12/31/a. Materials received between 12/31 and 1/5, cost $402.40 (Invoice cost). Factory was shut down during first week in January, 19x.

Scrutiny of purchase contracts develops the following;

1. Swan & Co., are to ship between Xmas and New Years', oak lumber and sheet steel amounting to $790.80. Shipment was f.o.b. shipping point. Correspondence file produced letter dated 1/2/x, that Swan & Co. had delivered to carrier, as contracted for, on 12/29/a.

Real Estate and Buildings. — An analysis of this account produced the following results:

1. As to charges:	
a. Land acquired 1/10/aa, by issue of 50 shares of preferred stock and 50 shares of common stock, from Mr. Hancock	$10,000.00
b. Land purchased for cash, January 15, 19aa	6,000.00
c. Expended in 19aa, up to and including April 19aa: Net material cost, $6,500.00; discount on above sent to Purchases account, $150.00; erection labor, $11,200.00; management supervision (portion of annual salaries), 500.00; portion of office expenses, $250.00; interest on outlay to date of completion, $200.00; profit transferred to Profit and Loss, $1,200.00 . .	20,000.00
d. Additions to June 30, 19a, $2,200.00; additions subsequent thereto, $800.00, ending October 31, 19a .	3,000.00
e. On 1/1/a, the assessed value of the property caused the Board to order an increase in book value . . .	12,000.00
f. In March 19a, the cost of replacing coping and portion of roof on one building, due to disintegration on part of frost and ice during winter	950.00
	$51,950.00
2. As to credits:	
a. Depreciation as of 12/31/aa, 5% on $20,000.00 . .	$ 1,000.00

Property deeds, title abstracts, contracts, etc., were seen. Property deeds never recorded. Building foundations of concrete; superstructures of brick.

Depreciation rate taken not to be less than 3% per annum, and as much more as may be desired. Same to be considered on basis of years and months.

Machinery — Tools — Equipment. — An examination of this account, and allied information, produced the following: The first debit occurred as of April 30, 19aa, at which time purchases were debited thereto, $24,697.65, plus installation charges of $302.35. During the year 19aa, the following additions are noted: August 15, purchases of $3,500.00; September 30, purchases of $3,000.50; November 15, purchases of $1,841.75, plus cost of removing machines incidental to new installation, $158.75; December 1, purchases of $1,969.00 gross, less sale price of one machine purchased on April 30, *ante*, or $470.00, making a net entry of $1,499.00. The machine which was sold cost $425.00.

On April 15, 19a, purchases amounted to $4,510.60; relative to these additions, a purchase discount was received of $225.53, when bill was paid, this latter amount being credited to Purchases account. On August 1, 19a, additional purchases amounted to $2,489.40; in this latter amount, $276.40 represented the cost of moving one machine to permit of more economical operation including reinstallation.

The total debits to the account amount to $42,000.00.

On December 31, 19aa, a credit was made of $2,000.00, covering depreciation for the year, this being 8% on $25,000.00, the total of the debit made on April 30, 19aa. On December 31, 19a, two depreciation credits are noted: one of 4% on $25,000.00, entered as $1,050.00, and one of 8% on $10,000.00; this latter $10,000.00 represents the additions during 19aa, exclusive of the $25,000.00, mentioned above (amount entered, $800.00). These represent all the credits to the account in two years, the total thereof as booked being $3,850.00.

It is decided that the charges for machine removal and reinstallation shall be written off in three years, each one, the first $\frac{1}{3}$ to be written off during the year in which the charge originated.

As of March 1, 19a, the employees finished assembling and setting up a new machine (not yet installed) consuming there-

under $211.20 in labor and $106.18 in material. These charges are not included above, having been booked to date only as labor and purchases.

Perishable tools thus far have been charged to Factory Expense and Supplies account. On December 31, 19aa, the inventory thereof was $316.75. Purchases between 1/1 and 12/31, in 19a, were $487.38. The inventory on December 31, 19a, was $405.40.

The depreciation rate used should be in excess of 10% per annum. Calculate on basis of either even or half months.

Auto Equipment. — The debits to this account comprise the following:

1/15/aa	Auto No. 1	$1,000.00
7/1/aa	Autos Nos. 2-4 ($1,000.00 each)	3,000.00
1/2/a	Auto No. 5	1,200.00
2/1/a	Auto No. 6	1,200.00
		$6,400.00

The offsetting credits are as under:

12/31/aa	Depreciation — 15 % of $4,000.00	$ 600.00
2/1/a	Auto No. 2	650.00
4/1/a	Auto No. 4	450.00
		$1,700.00

Auto No. 5 was purchased to replace No. 1, which was discarded because of an accident. Estimated that No. 1 could be placed in good condition for $250.00, after which it would have a value of $400.00.

Auto No. 2 was traded in against No. 6 for $650.00.

Auto No. 4 was partially destroyed by fire in March 19a; sold for $450.00 on April 1, 19a. No insurance carried.

Consider maximum life as not to exceed three years.

Sprinkler System. — One debit in this account represents first payment made thereon October 1, 19a. The contract price was $3,000.00, balance payable being covered by installment notes falling due every three months, each for $600.00: January 1, 19x; April 1, 19x; July 1, 19x; October 1, 19x.

Furniture and Fixtures. — This account is composed of the following:

1. Debits:			
	January 1, 19a	Balance	$2,120.00
	February 1, 19a	P. J. (Office Phone System)	130.00
	May 15, 19a	V. R. (Office Wall Cabinets)	260.00
			$2,510.00
2. Credits:			
	December 31, 19a	J. (Depreciation)	$ 424.00
		Balance	2,086.00
			$2,510.00

The balance at the first of the year is composed of the following: Furniture at 90% of cost, $810.00, divided as between factory, $216.00, and office, $594.00; equipment at 80% of cost, $720.00, divided as between factory, $240.00, and office, $480.00; office partitions at cost, $300.00; office lighting system at 80% of cost, $290.00.

The furniture in the opening balance was purchased on January 15, 19aa; the equipment was purchased on February 14, 19aa; the partitions were erected in April, 19aa; the lighting system was installed in July, 19aa.

The debit of $260.00, on May 15, 19a, represents material, $220.00, and labor, $40.00.

The depreciation covers only the opening balance. Depreciate partitions 15% per annum; phone system 20%; wall cabinets 20%.

Patents — Trademarks — Goodwill. —

1. Debits:			
	19aa		
	February 1,	J.	$2,000.00
	19a		
	March 1,	J.	1,000.00
	March 15,	V. R.	165.50
	October 15,	V. R.	480.00
			$3,645.50
2. Credits:			
	19a		
	November 1,	C. B.	$1,080.00
	December 31,	Balance	2,565.50
			$3,645.50
3.	January 1, 19x	Balance	$2,565.50

The entry of February 1, 19aa, represents patent purchased from J. B. Hancock for a steel filing cabinet, same being issued to him on February 15, 19aaa. The entry of March 1, 19a, repre-

sents cost of an advertising campaign from January 1, 19aa–April 1, 19aa; the entry of March 15, 19a, represents expense of securing a trade-mark; the entry of October 15, 19a, represents cost of suit against infringement brought by Hancock Mfg. Co.

The credit on November 1, 19a, represents payment of a judgment to Hancock Mfg. Co. in litigation to protect patent on filing cabinet mentioned above.

It developed that although the above patent was entered at $2,000.00 and credited against surplus, this agreeing with minutes, J. B. H. secured therefor, in lieu of cash, 55 shares of common stock, and 50 shares of preferred.

Treasury Stock. —

19aa January	15	J.	$10,000.00	19aa April	1	C. B.	$ 4,950.00
				19a Dec.	31	Balance	5,050.00
			$10,000.00				$10,000.00
19x January	1	Balance	$ 5,050.00				

The debit represents: 50 shares of preferred stock originally issued Mr. Hancock, and 50 shares of preferred subsequently secured by him, donated to Company for surplus purposes.

The credit on April 1, 19aa, represents 55 shares sold at 90.

Customers (Control).

1. Debits:

19a		
January 1	Balance	$17,000.00
January 31	S. B.	19,460.40
February 28	S. B.	14,310.82
March 31	S. B.	12,489.30
April 30	S. B.	14,541.62
May 31	S. B.	12,630.87
June 30	S. B.	10,408.81
July 28	J.	3,200.00
July 31	S. B.	12,402.20
August 31	S. B.	11,374.68
September 29	S. B.	11,771.86
October 31	S. B.	11,410.87
November 30	S. B.	14,406.41
December 31	S. B.	19,472.16
		$184,880.00

2. Credits:

19a		
January 31	C. B.	$ 18,614.88
January 31	S. R.	542.61
February 28	C. B.	8,509.19
February 28	S. R.	819.40
March 31	C. B.	10,002.33
March 31	S. R.	417.36
April 30	C. B.	10,401.20
April 30	S. R.	741.89
May 31	C. B.	6,295.67
May 31	S. R.	625.53
June 30	C. B.	7,412.90
June 30	S. R.	548.13
July 1	J. (N. Rec.)	892.50
July 31	C. B.	8,897.46
July 31	S. R.	419.81
August 1	J. (N. Rec.)	946.00
August 1	J. (N. Rec.)	1,500.00
August 31	C. B.	8,482.19
August 31	S. R.	742.65
September 29	C. B.	8,981.87
September 29	S. R.	730.14
October 3	J. (N. Rec.)	750.00
October 31	C. B.	10,606.18
October 31	S. R.	619.62
November 30	C. B.	8,101.99
November 30	S. R.	413.97
December 1	J. (N. Rec.)	1,800.00
December 31	C. B.	15,805.64
December 31	S. R.	378.89
December 31	Balance	49,880.00
		$184,880.00
19x		
January 1	Balance	$ 49,880.00

The opening balance on January 1, 19a, consisted of the following:

1. Advances to Salesmen:		
Eldred Scott (still employed)	$ 896.40	
August Bent (discharged August 1, 19aa)	1,210.80	$ 2,107.20
2. Customers' balances:		
Good and collectible, being collected in 19a	$11,392.80	
Doubtful of collection, not collected in 19a	2,000.00	
Worthless, not collected in 19a	1,500.00	14,892.80
Total		$17,000.00

Checking out the 19a accounts of the Customers' Ledger Abstract, confirmation and examination of the open balances at that time produced the following balances as existing on 12/31/a:

Name	Mo. of Sale	Remarks	Amount	Cr. Balance	False Cr.
Able & Sand	Dec.		$ 1,210.60		$ 500.00
Arthur & Bart	Nov.		842.20		
Bartlett, A. C.	Nov.		1,000.00		
Black & White	Nov.		591.65		
Crosby & Co.	Dec.		1,341.74		
Doe, John	Dec.		2,060.80		1,000.00
Donovan, M. T.	Oct.		2,000.00		
Dunlop & Smith	Dec.		8.50		
Eberle & Jones	Nov.		150.00		
Ellis Supply House	Oct.		1,791.50		
Envoy & Co.	Dec.		1,790.63		500.00
Frued & Co.	Aug.		1,300.00		
Franklin, Supplier		Consgmt.	3,600.00		
Goddard & Sons	Nov.		1,019.08		
Goldschmidt & Epstein	July		1,900.00		
Hancock, J. B.	July		3,200.00		
Harlow, Appliances	Dec.		1,715.30		500.00
Hendricks & Sons				$210.50	
Hoople & Hoople	Nov.		1,821.16		
Isaacs & Brogue	Dec.		1,201.10		
Jennings & Kohn	Nov.		50.60		
Jerry & Stoddard	June		480.00		
King & Earls	Dec.		1,740.19		
Kuechly & Borgard				140.20	
Little & Small	Dec.		1,802.20		
Lawrence & Sons	Dec.		1,101.90		500.00
Martin Desk Co.	Nov.		495.75		
Monroe & Adams Co.	Dec.		1,403.00		
Montreal Stat. Co.	Nov.		110.00		
Noble & Bryant	May		520.00		
Norton & Sweeney	Dec.		402.80		
Office Supply Co.	Nov.		1,010.20		500.00
Oppenheim & Tickner	Dec.		504.90		
Prague Appliances	Nov.		10.50		
M. Romann	Dec.		301.05		
Rogers & Smith	Dec.		1,410.00		
Solid Furniture Co.	Dec.		208.50		
Tarbell & Bacon	Nov.		1,813.75		1,000.00
Urdahl & Olney	Nov.		1,403.08		500.00
Waters & Vernon				56.80	
Yaulin & Snells	Dec.		1,367.62		
			$44,680.30	$407.50	$5,000.00
			407.50		
Net Customers' Balances 19a			$44,272.80		
Net Customers' Balances 19aa			5,607.20		
Total Per Control 12/31/a			$49,880.00		
False Credits in the Accounts			$5,000.00		
Credit Footings Over			2,000.00		

Conference with Hancock and Henning resulted in agreeing to the following:

1. The worthless accounts of 19aa are to be held on the Ledger but reserved against fully, until each case pushed to judgment.

2. The doubtful items of 19aa are to be reserved against 30%.
3. The reserve against uncollectibility of accounts originating in 19a is to be:
   a. Three months and over, 10%.
   b. Less than three months, 3%.

Sales. — The balance herein is summarized as follows: Customers, $161,080.00; Consignments, $3,600.00; Sales Returns and Allowances, $7,000.50. Net Balance, $157,679.50.

An analysis of the Sales Returns and Allowances produces the following:

	Total	Returns	Allowances
January 31	$ 543.11	$ 501.20	$ 41.91
February 28	819.40	305.18	514.22
March 31	417.36	327.20	90.16
April 30	741.89	520.70	221.19
May 31	625.53	520.13	105.40
June 30	548.13	318.10	230.03
July 31	419.81	399.01	20.80
August 31	742.65	632.49	110.16
September 29	730.14	540.06	190.08
October 31	619.62	453.82	165.80
November 30	413.97	304.02	109.95
December 31	378.89	378.89	
	$7,000.50	$5,200.80	$1,799.70

Raw Material Sales. — Covers sale of raw materials at average addition of 10% on cost; total balance, $8,000.00.

Purchases. — As analyzed and summarized:

1. Debits:			
19a			
January 1	Balance:		
	Raw material inventory	$12,000.00	
	Goods in process	7,000.00	
	Finished goods	15,000.00	$ 34,000.00
Jan. 1–Dec. 31	Purchases (Inclusive of false Dr. mentioned previously)		75,000.00
	Total Debits		$109,000.00
2. Credits:			
19a			
Jan. 1–Dec. 31	Purchase Returns		$ 780.00
Jan. 1–Dec. 31	Purchase Discounts		893.50
December 31	Balance		107,326.50
	Total Credits		$109,000.00
3. 19x			
January 1	Balance		107,326.50

The opening inventory balance was calculated as under:

Raw materials: Cost	$11,000.00	
Markup (Market being $14,000.00)	1,000.00	$12,000.00
Goods in process: Direct labor and material cost	$ 6,000.00	
Estimated overhead	1,000.00	7,000.00
Finished Goods: Sales value	$20,000.00	
Less: 25%	5,000.00	15,000.00
Direct labor and material cost	$12,000.00	

The purchases between January 1 and December 31, 19a, have been summarized, for presentation, to save space.

There are no purchase allowances.

Labor. — Upon analysis, this account is found to represent labor paid during 19a. Payrolls unpaid on 12/31/a amount to $1,500.00; those unpaid on 12/31/aa, paid during the first part of 19a, amount to $780.00.

Analysis produced the following:

Direct:	$585.00	$1,125.00	$21,000.00
Indirect:	195.00	375.00	4,000.00
	$780.00	$1,500.00	$25,000.00

Fuel. — Purchases booked at cost. Inventory at cost on 12/31/aa was $400.00; on 12/31/a, $200.00. Balance in account, $5,400.00.

Repairs — Machinery. — Includes $800.00 of salary of factory manager, entry having been made therein because of assumed smallness of account balance. Balance in account, $2,500.00.

Depreciation — Machinery, Tools, etc. —

1. Debit:		
19a		
December 31	Machinery, Tools, Equipment	$1,850.00

Taxes. —

1. Debits:		
19a		
January 1	C.B.	220.00
April 1	C.B.	275.00
July 1	C.B.	275.00
July 1	C.B.	100.00
October 1	C.B.	275.00
		$1,145.00

Analysis:	State and Local	$1,045.00
	Corporation	100.00
		$1,145.00

State and local taxes due April 1 of each year; payable quarterly. Assessment on April 1, 19a, was $1,100.00.

Factory Expense and Supplies. — Analysis produced the following:

Perishable tools	$487.38
Heat & Power	2,130.80
Light	486.75
Superintendence	1,300.00
Sundry supplies	5,416.07
	$9,821.00

Salesmen — Salaries & Expenses. — Total charges as under:

1. Salaries:			
December 19aa	$ 225.00		
Year 19a	2,775.00	$3,000.00	
2. Expenses:			
December 19aa	$ 110.50		
Year 19a.	1,889.50	2,000.00	$5,000.00
Expense reports on hand in January 19x, applicable to 19a . .			$108.10
Salaries due in 19a, not paid until January 19x			80.00

Advertising. — Includes the following:

Advertising during 19a	$1,399.50	
Advertising applicable to 19x	200.50	
Cost of installing arc light, etc., near plant to light road thereabouts for persons passing that way (June 19a)	500.00	
Portion of salary of J. B. Hancock	1,500.00	
Portion of salary of factory manager	900.00	
Dividends paid during 19a	4,500.00	$9.000.00

Office Salaries. — Consists of:

1. Officers		$7,500.00	
2. Clerical:			
a. Factory	$2,600.00		
b. General	2,400.00	5,000.00	$12,500.00

Office Expense & Supplies. — No comment; balance, $3,200.00.

Depreciation — Furniture & Fixtures. — Account was debited on 12/31/a, when Furniture and Fixtures account was credited; balance, $424.00.

Sales Discount. — Balance represents discounts granted, $950.00.

Interest. —

1. Analysis of debits:			
Interest on Mortgage Payable . .	$300.00		
Interest on Bank Loans	931.10		
Interest on Notes Payable	105.40	$1,336.50	
2. Analysis of credits:			
Interest on Notes Receivable . . .	$168.14		
Interest on Bank Balances . . .	44.05	212.19	$1,124.31

Insurance. — Coverage as under:

1. General office:		
Three-year fire policy		
Expires September 30, two years beyond year of audited Balance Sheet		
Premium paid		$ 51.18
2. Factory:		
Mutual policy		
Three-year term		
Valuation covered:		
Buildings	$18,000.00	
Machinery, Tools, Equipment	35,000.00	
Stock	30,000.00	
Furniture	1,000.00	
Total	$84,000.00	
Rate: $3.1802 per $1,000.00 per year		
Return to insured parties in past has averaged 20% per annum		
Premium paid, July 1, 19aa		801.41
3. Employers' Liability-Factory:		
One-year term		
Expires January 1, 19x		
Rate: 35¢ per $100.00 in factory		
15¢ per $100.00 in factory office and for superintendent		
Premium paid, January 1, 19a		94.45
		$947.04

Mortgage on Real Estate. — Mortgage on property and plant taken out July 1, 19aa, interest at 6%, payable quarterly. The interest payment due on January 1, 19a, was paid on 12/31/aa.

Creditors' Accounts. — No comment; account balance, $4,300.00.

Capital Stock. — The credits herein represent:

1. Preferred stock	$50,000.00	
2. Common stock	60,000.00	$110,000.00

Further analysis produced:

1. Preferred stock:	
a. Issued for land	$ 5,000.00
b. Sundry sales	45,000.00
2. Common Stock:	
a. Issued for land	$ 5,000.00
b. Sundry sales	55,000.00

Stock Certificate Books show:

1. Preferred stock: Issues in excess of account credits therefor, 50 shares.
2. Common stock: Issues in excess of account credits therefor, 55 shares.

Interest Received. — Analysis shows:

1. Sundry interest received (accounts and notes)	$1,000.00	
2. Dividends on stock	300.00	
3. Bond interest	525.00	$1,825.00

Requirements of Problem. — Upon the basis of the above facts, prepare:

1. Working papers indexed properly
2. Audit Report as of 12/31/a, embracing:
   a. Letter of Submittal
   b. Audit Comments
   c. Statements, with Certificate of Audit
   d. System Comments

APPENDIX

APPENDIX

Index to Questions and Problems

CHAPTER	QUESTIONS	PROBLEMS
1	1–17	none
2	18–40	1–4
3	41–59	5–8
4	60–79	9–12
5	80–99	13–16
6	100–128	17–20
7	129–149	21–24
8	150–186	25–28
9	187–233	29–33
10	234–282	34–37
11	283–325	38–41
12	326–350	42–45
13	351–387	46–50
14	none	51–52
15	none	none

Questions on Chapter I

1. Define " audit." (C.P.A.)
2. State the objects to be attained by an audit. (C.P.A.)
3. What meaning attaches to the term "auditing" other than the review and verification of accounts of past transactions? (C.P.A.)
4. Explain how certified statements extending over a period of years might facilitate the sale of a business. (C.P.A.)
5. Define and illustrate:
   a. Technical error
   b. Error of principle
   c. Compensating error (C.P.A.)
6. Mention five of the technical errors that frequently occur in the keeping of accounts, and give the method of detecting them. (C.P.A.)
7. What is the principal effect of errors of principle? In what part of the accounts are they most apt to be found? (C.P.A.)
8. The A1 Mfg. Co. employs a staff of bookkeepers. The head bookkeeper has not studied the theory of accounting, neither has his experience been extensive. He understands double-entry bookkeeping, but he cannot be described as a well-trained accountant.

Previously the A1 Mfg. Co. has been satisfied with annual accounts prepared by competent auditors. They decide to have monthly statements of accounts in the future, and with this end in view, instruct the head bookkeeper to prepare statements on the same lines as the last annual accounts were prepared.

State several imaginary errors of principle that might not unreasonably be found upon an expert examination of his work. (C.P.A.)

9. Define in your own words:
   a. A bookkeeper
   b. An accountant
   c. An auditor
   d. A practicing public accountant and auditor (C.P.A.)
10. In contra-distinction to the duties of an auditor, what are, generally, those of an accountant? (C.P.A.)
11. In large businesses internal auditors, members of the staff of the concern, are frequently the only ones employed. Where this is the case, do you think it desirable professional Certified Public Accountants should be engaged? If so, give your reasons. (C.P.A.)
12. State what are the advantages of the certified public accountant (C.P.A.) degree to:
   a. The accountant
   b. The client (C.P.A.)
13. What are the responsibilities of an auditor? (C.P.A.)
14. To what extent is an auditor:
   a. Morally, and
   b. Legally
   responsible for his certificate? (C.P.A.)
15. Define the different responsibilities of an auditor of the accounts of:
   a. An individual
   b. A firm
   c. A corporation
16. State the training necessary to fit an auditor for the discharge of his duties. (C.P.A.)
17. To what extent and for what purposes should an auditor be familiar with:
   a. Law
   b. Algebra
   c. Economics
   d. Financial history (C.P.A.)

Questions on Chapter II

18. Explain the difference between capital expenditure and revenue expenditure. What rule controls in determining whether certain payments belong to capital or to revenue? When in doubt, to which should the payment be charged? (C.P.A.)
19. What is the auditor's general duty in regard to capital expenditures? (A.I.A.)
20. If in the course of an audit it should be found that capital expenditures had been charged up against Profit and Loss account, what would be the duty of the auditor in respect to such charges? (A.I.A.)
21. State which of the following should be charged to capital account and which to revenue account:
   a. Repairs to machinery and plant
   b. Replacements of plant and machinery
   c. New plant purchased
   d. Cost of leasehold premises (C.P.A.)
22. Expenditures are made by a corporation for items of each of the following classes:
   a. Taking down a machine in one part of factory, moving it, and putting it up in another part
   b. Expenses of incorporating the company, including state charges and lawyer's services
   c. Brokerage on purchase of a piece of property
   d. Commission on an issue of debenture bonds
   e. Costs attending a mortgage
   f. Costs of patents, including solicitor's charges and government fees (C.P.A.)
23. A corporation acquires several plants that are found to be run down and in poor condition, and they require extensive outlay for repairs and renewals to bring them to the required state of efficiency. Should outlay be charged against capital or against revenue? Give your reasons fully. (C.P.A.)
24. It has been stated that "revenue expenditures do not create assets." What is your opinion? (C.P.A.)
25. *a.* Define "internal check" and give five suggestions with a view to efficient control and the prevention and detection of fraud.
   b. What condition of office organization, above all others, leads to fraud and defalcation by bookkeepers and cashiers? Support your opinion. (C.P.A.)
26. How far are the duties of an accountant auditing the books of

a company affected by the character and extent of the company's system of internal check? (A.I.A.)

27. How is the position of an auditor affected if the system of the concern under audit is defective as to internal check? (A.I.A.)
28. Outline a system of internal checks for a wholesale grocery concern doing a business of $3,000,000.00 a year, with about 2,000 customers. The system should coördinate with an annual audit by professional accountants. (A.I.A.)
29. What do you understand to be meant by a Balance Sheet audit? What is its scope? (A.I.A.)
30. Define:
    a. Completed audit
    b. Periodical audit
    c. General audit
    d. Payroll audit
    e. Cash audit (C.P.A.)
31. State concisely your understanding of the purpose of and the difference between the following kinds of audits, indicating briefly your conception in the absence of special instruction of the extent of your responsibility in each case, whose interests you would consider yourself obligated to protect. You may assume the audits relate to a corporation:
    a. Continuous or periodical cash audit
    b. Annual audit (A.I.A.)
32. Define and state the scope of:
    a. Complete audit
    b. Continuous audit
    c. Special examination (C.P.A.)
33. You receive the following letter: "We have never had our books audited, but are contemplating an audit now. Two of our friends have recommended you to us. Both have businesses similar to ours, but their advices as to the time required are very different. Do you carry out different kinds of audits? If so, what are the different kinds and under what circumstances do you recommend one kind and when another." Write a reply. (A.I.A.)
34. Would you recommend that a client have his books audited monthly, yearly, or on special occasions only? Give full reasons for your recommendation and the relative merits of each plan. (C.P.A.)
35. In making an audit what should an auditor do under the following conditions or instructions:
    a. With limitation

    b. Without limitation
    c. Where an audit has been previously made to a certain date (C.P.A.)
36. Does an auditor's duty in any way extend beyond the careful examination and certifying of the books and accounts submitted to him? Discuss different theories. (C.P.A.)
37. Is it an auditor's duty to concern himself, to any extent, with the validity of the transactions that come under his notice? Explain. (C.P.A.)
38. As to audit working papers:
    a. What are they?
    b. What are their purposes?
39. As to audit working papers:
    a. How are they to be headed and marked?
    b. What should be included in them?
40. What is your idea of the proper and a just charge or compensation:
    a. To the employer and the employee for your services as a C.P.A.
    b. To the services of a first assistant
    c. To other assistants (C.P.A.)

Problems on Chapter II

Problem 1

The following are summarized trial balances of a manufacturing company as of June 30, 1924, and December 31, 1923:

	6/30/24		*12/31/23*	
Capital Stock		300,000.00		300,000.00
Bonds		100,000.00		100,000.00
Cash	34,321.90		25,127.96	
Inventory	396,609.50		351,362.14	
Accounts Payable		19,690.23		15,256.59
Accounts Receivable	54,009.16		24,200.50	
Land, Buildings, Etc.	115,602.73		110,910.54	
Stocks and Bonds	22,321.14		21,650.36	
Unexpired Insurance	1,824.67		1,550.25	
Surplus		119,445.16		119,545.16
Profit and Loss, 1924		85,553.71		
	624,689.10	624,689.10	534,801.75	534,801.75

The books of the company were audited as at December 31, 1923, and in making up the accounts at that date, the auditors made the following adjustments:

1. Transferred to Profit and Loss, $8,462.14, which had been improperly charged to Land and Buildings
2. Wrote off $3,600.00 for depreciation of buildings, etc.
3. Brought into Expense account liabilities amounting to $1,250.00 which had been incurred in 1923 but were not entered on the books until January 1924
4. Reduced the value of the inventory by $14,920.00

The auditors were again called in at June 30, 1924, and found that the adjustments made by them at the previous audit had been ignored so far as the books were concerned. They also found that during the half year $1,000.00 had been charged to Buildings instead of to Expense account; that no provision had been made during the year for depreciation, amounting to $1,800.00, and that the inventory of June 30, was overvalued to the extent of $9,840.00. On the other hand, the insurance unexpired was incorrectly calculated and should have been $2,774.67 instead of $1,824.67.

Requirements:

1. Prepare the audited Balance Sheet at June 30, 1924.
2. State the amount of the profits for the half year as audited.
3. Prepare schedules showing how the audited Balance Sheet is made up and how it can be connected with the book figures. (C.P.A.)

PROBLEM 2

The following are condensed trial balances of the X Manufacturing Company's books as the auditor found them as of December 31, 1923, and June 30, 1924:

	6/30/24		12/31/23	
Land, Buildings, Etc.	115,226.80		102,840.26	
Capital Stock		200,000.00		200,000.00
Bonds		100,000.00		100,000.00
Cash	22,143.21		14,672.14	
Accounts Payable		11,698.21		9,431.17
Accounts Receivable	28,250.40		22,436.10	
Loans		5,000.00		10,000.00
Stocks and Bonds	19,150.00		17,502.50	
Inventory	288,360.14		246,153.42	
Unexpired Insurance	742.26		1,471.23	
Surplus		85,644.48		85,644.48
Profit and Loss, 1924		71,530.12		
	473,872.81	473,872.81	405,075.65	405,075.65

The books of this company were audited to December 31, 1923, and in making up the Balance Sheet and Profit and Loss Statement at that date the auditors recommended the following adjustments:

1. Transferred to Profit and Loss $4,231.07 which had been charged to Land and Buildings in error
2. Provided for depreciation of buildings, etc. $7,200.00
3. Adjusted salaries amounting to $1,400.00 due for 1923 services but not entered on the books until January 1924
4. Reduced the amount of inventory because of errors $12,000.00

The same auditors were again called in to audit the books to June 30, 1924, and found that the above adjustments had not been entered on the books. They also found that during the half year $1,000.00 had been charged to Land, Buildings, Etc., instead of to Expense; that no provision had been made for depreciation for the period, amounting to $3,600.00; and that the inventory had been footed $10,000.00 too much. Also that the unexpired insurance amounted to $750.00 more than was entered on the books.

From the above facts prepare:

1. A correct Balance Sheet, June 30, 1924.
2. State the adjusted amount of profits for the half year to June 30, 1924.
3. Prepare statement reconciling the Balance Sheet figures with the original trial balance of June 30, 1924. (C.P.A.)

PROBLEM 3

The following is the Balance Sheet of the A. B. Company, January 1, 1923:

Cash	52,864.00	Accounts Payable	35,482.00
Accounts Receivable	197,425.00	Dividends Payable, Pfd. Stock, Feb. 1, 1923	7,500.00
Inventories:			
Raw Material	84,268.00	Dividends Payable, Com. Stock, Feb. 1, 1923	10,000.00
Finished Goods	31,597.00		
Office Furniture and Fixtures	7,500.00	Mortgage Bonds, 20 Year 6%, Dated Jan. 1, 1923	100,000.00
Land	180,000.00	Premium on Bonds	5,000.00
Buildings	150,000.00	Capital Stock Preferred	250,000.00
Machinery	250,000.00	Capital Stock Common	500,000.00
		Reserve for Bad Debts	4,718.00
		Surplus	40,954.00
	953,654.00		953,654.00

The transactions for the year ending January 1, 1924, have been as follows: Cash received from customers, $793,501.00; rent received, $600.00. There has been purchased 1,232,000 pounds raw material

at 20 cents per pound. Sales have been $823,334.00; discount and allowance on sales, $23,519.00; bad debts written off, $2,143.00.

Disbursements have been made for: Accounts Payable, $243,356.00; Factory Expense, $7,489.00; Factory Labor, $351,426.00; Factory Repairs, $23,843.00; Office Expense, $1,927.00; Selling Expense, $52,914.00; Salaries, $58,471.00; Taxes, $7,853.00.

Inventories January 1, 1924: Raw Material, 412,595 pounds, having market value of 22 cents per pound; finished goods, $30,842.00.

The land is estimated to be worth $200,000.00. Semiannual dividends of 3 per cent on preferred and 2 per cent on common, declared in June and December, payable August 1 and February 1. Reserves for depreciation of building, 3 per cent; machinery, 5 per cent; office fixtures, 10 per cent. Bad and doubtful debts reserve should be 2 per cent of Accounts Receivable.

Prepare an Operating Statement and Balance Sheet as on January 1, 1924. (A.I.A.)

Problem 4

The trial balance of the Interstate Manufacturing Company, on June 30, 1923, after closing entries have been made, is given below:

Patents and Goodwill	250,000.00	
Office Furniture	8,746.00	
Inventory, June 30, 1923:		
Raw Material	83,247.00	
Supplies	4,932.00	
Finished Goods	42,761.00	
Petty Cash	100.00	
Land	270,000.00	
Buildings	165,000.00	
Cash subject to check	69,433.00	
Machinery	235,000.00	
Accounts Receivable	273,842.00	
Common Capital Stock		500,000.00
Preferred Capital Stock		500,000.00
Bonds 6%, 50-year First Mtge., issued June 30, 1923		200,000.00
Premium on Bonds		20,000.00
Preferred Stock Dividends, payable August 1923		17,500.00
Common Stock Dividends, payable August 1923		12,500.00
Reserve for Bad and Doubtful Accounts		8,294.00
Undivided Surplus		66,375.00
Accounts Payable		78,392.00
	1,403,061.00	1,403,061.00

During the year ending June 30, 1924, the company purchased 29,047 tons of raw material at $22 per ton, which was delivered before the books closed. Of the amount purchased, payment has been made for 26,647 tons.

They have also made payments for the following accounts: Accounts Payable, $78,392.00; Salaries, $80,360.00; Selling Expense, $86,017.00; Labor, $468,932.00; Shop Expense, $9,461.00; Repairs and Maintenance, $30,955.00; Taxes, $7,842.00; Office Expense, $2,478.00; and Supplies, $37,637.00.

Customers have paid $1,502,927 in cash and have been given discounts amounting to $18,395.00. Returns and allowances amount to $8,474.00. Bad debts written off, $2,407.00; rents received, $500.00; and sales, $1,515,572.00. $50,000.00 was borrowed on call on June 30, 1924, the market value of the collateral security being $72,100.00.

The inventory on June 30, 1924, is made up of finished goods, $20,495.00; supplies, $8,129.00; and 2,163 tons of raw material, the market price of which is $24.00 per ton. The land is estimated to be worth $300,000.00.

Semiannual dividends of $3\frac{1}{2}$ per cent on the preferred stock and $2\frac{1}{2}$ per cent on the common stock have been paid from the earnings of the half year ending December 31, 1923. Dividends at the same rate have been declared on the preferred and common stock for the last half of the fiscal year, payable in August 1924.

You are asked to set up a Balance Sheet dated June 30, 1924, and accompany it with a statement which will show correctly the operation of the company.

The following annual rates of depreciation are to be assumed: Buildings, 3 per cent; machinery, $7\frac{1}{2}$ per cent; office furniture, 10 per cent. It is also assumed that there should be a reserve for bad and doubtful accounts equal to 3 per cent of the balance of the accounts receivable. Calculate these percentages to the nearest dollar. (C.P.A.)

Questions on Chapter III

41. Why it is advisable to determine the legal responsibility of a possible client before accepting an assignment? (C.P.A.)
42. To whom is an auditor responsible? (C.P.A.)
43. Name the different kinds of persons who would have an interest in audit reports prepared for a corporation; indicate what the interest is, and show the responsibility of the auditor to each class. (C.P.A.)
44. To what extent should an auditor be governed by instructions? (C.P.A.)
45. How far should an auditor inquire into the work of his predecessor, and what circumstances might affect his decision on this point? (C.P.A.)

46. State, in the order of their importance, five rules for the guidance of a junior starting on his first audit. (C.P.A.)
47. Upon beginning the work of an audit of a company whose business and conduct of the same is comparatively unknown to you, how would you proceed, and what general precautions would you take? Give a brief outline of how you would spend the first day or two. (C.P.A.)
48. In the preparation of a Balance Sheet, explain the basis upon which you would ascertain that cash was properly valued. (C.P.A.)
49. Explain the advantages of verifying all cash balances simultaneously. (C.P.A.)
50. Upon taking up the audit of the accounts of the Jones Company, you are informed that three bank accounts are kept and that all receipts are deposited and all payments made by check. You find incidentally that the selection of banks is in the hands of the treasurer, but that all checks are countersigned by the president. State, concisely, in their order, the several steps you would take to verify the cash balance of the company at the date of your audit. (C.P.A.)
51. In a contemplated audit, at what time should the auditor make provision for the verification of cash? (C.P.A.)
52. At a financial or Balance Sheet audit made two or three weeks after the date of the Balance Sheet, would you consider it necessary to count the cash? Explain. (C.P.A.)
53. When would an auditor be justified in making a second count of the cash on hand? (C.P.A.)
54. What record should an auditor make to the count of cash on hand? (C.P.A.)
55. Your audit of the accounts of a corporation discloses that the cash balance at the end of the fiscal year consists of the following: Currency and coin; expense slips applicable to the period audited; advance on payrolls; personal slips of officers; protested check of customer.
    Indicate treatment of the above by the auditor for correct Balance Sheet set out of cash; show adjustments in *pro forma* form therefor.
56. State to what extent you are justified in accepting the certificates of officials of a corporation as to cash and bank balances? (C.P.A.)
57. Under what circumstances, if any, would you examine the securities owned by a corporation, and, if you think this course unnecessary, give your reasons why, and should you think it necessary, state how you would proceed in the event the securities are not in the company's possession. (C.P.A.)

58. What precautions should be taken to avoid substitution or other manipulation during the inspection of securities? (C.P.A.)
59. To what extent are you justified in accepting the certificates of officials of a corporation as to bonds and stocks of outside companies owned? (C.P.A.)

Problems on Chapter III

Problem 5

In connection with the audit being made for the year 1923, the cash count of the Johnson Manufacturing Company (Client M181), made as at 2 : 30 P.M., January 3, 1924, consists of the following items. The cashier was Oscar Nelson, and the count was made in his presence. The reported cash drawer balance was $200.00.

a. Currency and coin	$122.50
Bills: $20 — 20 — 10 — 10 — 10 — 5 — 5 — 5 — 5 — 2 — 2 — 2 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1	
Silver:	
Dollars: $1 — 1 — 1 — 1 — 1 — 1 — 1	
Cents: 50 — 50 — 50 — 25 — 25 — 25 — 25 — 25 — 25 25 — 25 — 25 — 25 — 25 — 25 — 25 — 25 — 25 25 — 25 — 25 — 25 — 25 10 — 10 — 10 — 10 — 10 — 10 — 10 10 — 10 — 10 — 10 — 10 — 10 — 10 10 — 10 — 10 — 10 — 10 — 10 — 10 10 — 10 — 10 — 10 — 10 — 10 — 10 10 — 10 — 10 — 10 — 10 — 10 — 10 — 5 — 5 5 — 5 — 5 — 5 — 5 — 5 — 5 — 5 — 5 — 5 — 5 5 — 5 — 5 — 5 — 5 — 5 — 5 — 5 — 1 — 1 — 1 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1 — 1	
b. Postage stamps (received from customers in payment of small balances and cashed from drawer)	17.50
20¢ : 20 + 8 10¢ : 30 + 25 + 5 6¢ : 25 + 23 4¢ : 22 2¢ : 50 + 40 + 4 1¢ : 26	
c. Slip inscribed "I.O.U., $20.00, J. B. S." (dated 12/26/23)	20.00
d. Check payable to "cash," signed by cashier and dated August 5, 1923	28.00
e. A slip inscribed "butter and eggs for Mr. Snow" (the Gen. Mgr.) (dated 12/28/23)	3.00
f. A receipted express bill for charges on a motor received from the Electric Company. You are informed this motor should have been sent prepaid (dated 1/2/24)	9.00
	$200.00

Prepare working sheet, properly headed up, covering the above count. Show necessary adjustments covering disposition of items not to be included in the audited Balance Sheet as cash.

Problem 6

A physical examination of the notes receivable on hand at the Johnson Manufacturing Company (as above) disclosed the following information; the examination was made on January 3, 1924.

1.	Atlas Company, dated July 6, 1923, due January 6, 1924; interest at 5%. Notes were signed as follows: "John Ryan, Treasurer, Atlas Company"	$915.20
2.	Beerbohm Smith, dated October 1, 1923, due March 1, 1924; interest at 6%	200.00
3.	Jasper & Jones, dated August 1, 1923, due November 1, 1923; interest at 6%. Note went to protest, protest charges were $1.75, which were charged by the bank against the company account, and were debited by the company to the account of Sales Office Expense	55.00

Prepare working sheet for the above, indicating the adjustments deemed necessary.

Problem 7

In auditing the accounts of Jacobs & Company, as at 12/31/23, a securities record and other sources revealed the following information relative to securities claimed as held. The securities themselves were physically examined at the bank. Amount per Trial Balance, $15,929.94.

Stock:

25 shares of P.Q. Com., purchased on 12/1/22, at 123 plus $\frac{1}{8}$. Par value $100.00. Dividends received during 1923, $300.00, were all credited to income. Reference to financial papers disclosed the market value on 12/29/23 as 99 . . . . . $3,078.13

Bonds:

7M. Con. G. Gold 4's, series of 1950; interest J & J.
Purchased on 11/21/22, with interest, @ $92\frac{3}{8}$, — $6,466.25 and interest $108.89. Market value on 12/30/23, was $91\frac{1}{2}$.
6M. Realtors' Corporation, Gtd. 5's; interest J & D.
Purchased on 5/30/23/ @ $102\frac{1}{8}$, with interest, — $6,127.50 and interest $149.17. No market on or near 12/31/23.
Interest received as and when due.
Prepare working sheet for the above, as of January 6, 1924, indicating the necessary adjustments as of 12/31/23.

Problem 8

On January 7, 1924, at 8:30 A.M., one senior accountant accompanied by two assistants arrived at the office of the Excelsior Manufacturing Company to audit its books for the year ended December 31, 1923. One junior, Wm. Scott, was assigned to count the cash, and prepare the requisite reconciliations, whereas the other junior, A. Dolf, was assigned the Notes Receivable.

Wm. Scott proceeded first by counting the cash on hand, which he found to consist of two funds, — cash undeposited, and a petty cash fund. The undeposited cash he began to count at 8:50 A.M., in the presence of J. Black, cashier. He encountered the following:

Checks:			
Honer & Company	1/5/24	$415.00	
Johnson & Straud	1/2/24	206.00	
Burkei & Stokes	1/10/24	708.00	
Edwards & Son	1/5/24	93.00	$1,422.00
Currency:			
$5.00 Bills	9	$45.00	
1.00 Bills	17	17.00	
Halves	25 + 7	16.00	
Quarters	11	2.75	
Dimes	25 + 18	4.30	
Nickels	19	.95	
Pennies	42	.42	86.42
I.O.U. of Cashier, dated 12/28/23			50.00
Check of H. Olin, dated 12/2/23, marked N. F.			90.00
	Total		$1,648.42

The petty cash count was made at 9:15 A.M., January 7, 1924, in the presence of Olga Rood, petty cashier. The following was found:

Bills:			
$10.00	11	$110.00	
1.00	10	10.00	$120.00
Silver, Etc.:			
$00.50	37	$18.50	
.25	41	10.25	
.10	121	12.10	
.05	43	2.15	
.01	96	.96	43.96
Vouchers:			
Nos. 8213	Dated 1/2/24	$8.00	
4	1/2/24	4.20	
5	1/2/24	1.10	
6	1/3/24	.59	
7	1/3/24	4.80	
8	1/4/24	3.62	
9	1/4/24	5.98	
20	1/5/24	7.02	
1	1/5/24	.76	36.07
	Total		$200.03

The Cash Book was footed for January, 1924, to date, inclusive of the transactions of 1/5/24, the footings being:

Debit	$65,482.20
Credit	37,760.01

A confirmation certificate was received from the First Second National Bank, certifying that on January 5, 1924, as of the close of the business day, the Excelsior Manufacturing Company had on deposit $28,431.08, inclusive of interest credited as of 12/31/23 of $41.02, and sundry charges to date of 12/31/23 of $11.09, and in January 1924, of $6.97. The canceled checks were returned.

The following checks were issued, but not yet cleared through the bank:

Nos.			
18106	12/2/23	Kartoun & Hennefoal	$201.75
18942	1/2/24	Nussbaum & Sons	102.50
18948	1/2/24	Kelly-Marvin Co.	14.90
18950	1/4/24	Bailey & Jones	78.60
18951	1/5/24	F. L. Bresee	110.20
18952	1/5/24	Stuart, Jones & Hanley	26.40
		Total	$534.35

The daily receipts per the Cash Book for January 1924, showed:

January 2	$1,846.02
3	418.90
4	714.20
5	500.00

The currency on hand January 7, 1924, represented cash sales, made on January 5. On December 28, 1923, a note of Watkins-Jensen Company, of Newcastle, dated 12/1/23, due 12/31/23, no interest, for $1,800.00, was sent to the bank for collection. No word has been received as yet from the bank concerning this note.

The cash balance per the Trial Balance on 12/31/23 was ascertained as $62,003.08; the petty cash account in this Trial Balance showed $200.00, as a balance.

A. Dolf proceeded to examine the notes on hand, and encountered the following:

1. J. B. Seymour, customer, dated November 1, 1923, due February 1, 1924, @ 6%	$1,250.00
2. R. Smith Co., customer, dated December 10, 1923, due January 10, 1924, @ 6%	480.00
3. L. Stone, Gen. Mgr., dated December 24, 1923, due March 24, 1924, @ 4%	1,000.00
Total	$2,730.00

Comment on notes:

1. Indorsed, H. Horan, Manager
2. Authorized by the Board of Directors

The Trial Balance of 12/31/23, shows notes receivable, $4,530.00.

Prepare all working papers and adjustments necessary in the premises.

Questions on Chapter IV

60. Is it necessary for the auditor to secure bank confirmation direct as to the balance therein on deposit as of a certain date where the bank statement of the past month has been handed him and seems to be in order in every way?
61. When an auditor employed to adjust the accounts of a firm finds that the current work is behind and that no Trial Balance has been made for over a year, what course should he pursue, having regard for his own interests as well as for those of the firm? (C.P.A.)
62. How should one proceed to detect an error in a Trial Balance? (C.P.A.)
63. Describe fully (or illustrate in skeleton form with proper captions if preferred) a Working Balance Sheet. (A.I.A.)
64. Describe in detail a form of comparative Working Trial Balance as used by an auditor in a Balance Sheet audit and illustrate, in connection therewith, the method of controlling accounting adjustments.
65. Set up a form of working paper that will enable an auditor to adjust a Trial Balance of January 1, with a Profit and Loss account and Balance Sheet of a subsequent period without recourse to the Journal entries. (C.P.A.)
66. Outside of the general financial books of an undertaking, what are the various kinds of documents and papers and other sources of information which are used or referred to by an auditor in the course of his work? Explain the object of such use or reference in each case. (C.P.A.)
67. What points should be covered in a partnership agreement? (C.P.A.)
68. What records and documents should an auditor have access to in an audit of a partnership? Give reasons. (C.P.A.)
69. In auditing the accounts of a corporation, for the first year of its existence, what records and documents should be examined in addition to the books of account and the vouchers? (C.P.A.)

70. Do you consider it necessary, and if so, why, for an auditor of a corporation to peruse the minutes of directors' and stockholders' meetings? (C.P.A.)
71. What should an auditor do in case he is refused access to the Minute Book? (C.P.A.)
72. What would you consider satisfactory evidence of the correctness and propriety of expenditures of directors' remuneration? (A.I.A.)
73. To what extent would you consider it necessary to verify the cash, and what reference to such verification would you make in your report? (C.P.A.)
74. What is the value of a bank Pass Book for the purposes of an audit? To what extent should it be taken as a voucher for Cash Book entries, or for the balance carried forward? (C.P.A.)
75. The Check Book of a company shows cash in bank, $12,500.00, the bank Pass Book for the same date shows $14,000.00; which is correct and which amount should be included in the Balance Sheet? (C.P.A.)
76. State what verification you would make of the Bank Book. (C.P.A.)
77. State fully the limitations of the process of verification of cash handlings where all receipts are deposited in banks and all disbursements made by bank checks. (C.P.A.)
78. If you should contract for an audit which provided for an examination of all vouchers, what would you accept as proper vouchers for cash receipts? (C.P.A.)
79. If the cash in bank per Cash Book or Ledger is reconciled with the amount shown by the Pass Book or bank confirmation certificate, should the Pass Book be checked with the deposits as shown by the Cash Book? If your answer be in the affirmative, state the nature of a possible irregularity that might be disclosed by such detail checking.

Problems on Chapter IV

Problem 9

You are retained by The Appliance Manufacturing Company to audit its accounts for the year ended June 30, 1924, and to prepare the requisite statements.

The company was incorporated on July 1, 1923, and its Balance Sheet on that date, which was prepared by you, showed as follows:

Assets

Cash	$ 12,680.92	
Notes Receivable	2,200.00	
Customers	19,501.33	
Merchandise on Hand	9,554.43	
Machinery & Tools	129,355.01	
Furniture in Office & Store	11,762.18	
Expenses of Incorporation	500.00	
Customers' Accounts in Suspense	1,983.40	
Goodwill	40,000.00	
Total		$227,537.27

Liabilities

Notes Payable	$ 10,901.07	
Creditors	15,617.04	
Capital Stock	200,000.00	
Reserve for Suspended Customers' Accounts	1,019.16	
Total		$227,537.27

The Trial Balance of June 30, 1924, was as follows:

Cash	$ 5,259.80	
Notes Receivable	5,048.75	
Notes Payable		$ 16,922.81
Sales		240,172.56
Materials & Supplies	52,088.94	
Sundry Merchandise Bought	2,869.80	
Selling Wages	22,400.04	
Manufacturing Wages	88,317.70	
Miscellaneous Receipts		549.20
Office Salaries	5,802.50	
Manufacturing Expenses	15,353.16	
Office Expenses	2,496.14	
General Selling Expenses	3,491.50	
Advertising	2,064.33	
Light, Heat, Power	3,121.97	
Rent of Factory	4,000.00	
Rent of Store & Office	1,860.29	
Repairs to Machinery, etc.	845.78	
Delivery Expenses	2,201.01	
Interest & Discount	738.40	
Commissions	5,089.30	
Machinery & Tools	132,817.24	
Dividend (paid January 10, 1924)	6,000.00	
Furniture, etc. in Store & Office	12,016.45	
Customers	58,935.20	
Creditors		18,311.16
Expenses of Incorporation	500.00	
Reserve for Suspended Customers' Accounts	320.59	
Goodwill	40,000.00	
Capital Stock		200,000.00
Customers' Accounts in Suspense	2,316.84	
	$475,955.73	$475,955.73

The inventory of merchandise and material amounts to $12,453.90. You discover the following facts not disclosed by the books:

(*a*) Invoices not entered:

Maryland Steel Co., dated June 15, 1924, for steel	$165.00	
York Safe & Lock Co., dated June 1, 1924, for office safe	110.00	
Vulcan Coal Co., dated May 20, 1924, for coal	42.50	$317.50

(*b*) The company made in its shop for its own use five machines, in the construction of which it used material costing $525.00, and the mechanics' wages amounted to $750.00.

Upon the basis of the above, prepare:

1. Basic control work sheet for a Balance Sheet audit
2. Basic control work sheet for a detailed audit

Comment: Save working papers hereunder for further use in connection with Problem 47 (*post*).

Problem 10

Work is commenced January 7, 1924, on an audit of the Twosy Automobile Sales Agency for the year ended December 31, 1923. On the basis of the following facts prepare a bank reconciliation (First National Bank):

Bank balance, per Cash Book, December 31	$15,657.26
Bank balance, per bank confirmation, January 5	17,819.37
Interest for December, charged by bank, per bank statement, not shown on Cash Book	142.00
Receipts deposited, January 2–5	2,623.04
Checks drawn, January 2–5	902.40
Checks outstanding on January 5:	
Nos. 1749	2.31
1767	150.00
1770	52.19
1772	98.45
1773	1.10
Miscellaneous bank charges, not on Cash Book	4.58

Problem 11

John H. Kelly attempted to reconcile his cash as at the close of business, December 31, 1923. He uncovered the following facts: Balance, per Cash Book, $2,964.41; balance per bank statement, $2,813.04 (Second National Bank); checks outstanding: No. 971, $2.80, No. 980, $41.60, No. 986, $17.50, No. 989, $108.40. Collection on out-of-town checks, charged by the bank, entered on the bank statement but not on the Cash Book was $2.40. Cash items on hand, not deposited, but entered on the Cash Book, $319.27.

Prepare Reconciliation Statement.

Problem 12

The following balances are found on the books of a trading concern at the end of its first fiscal year:

Inventory merchandise	$ 4,312.09
Salaries	4,622.89
Capital stock	10,000.00
Real estate, buildings, and fixtures	17,500.00
Sales	8,469.10
Notes Payable (merchandise creditors)	5,000.00
Mortgage bonds issued	15,000.00
Customers' accounts	5,423.23
Accounts payable (merchandise creditors)	2,436.28
Notes payable (bank)	5,000.00

Total merchandise purchases as per invoices on file, less inventory, show the cost of merchandise sold to be 97% of sales. The cash at bank and in hand amounted to $1,302.14.

From the foregoing, construct cash account and submit a brief report on same. (C.P.A.)

Questions on Chapter V

80. Presuming that upon examination of a merchant's accounts the balance shown by the bank Pass Book, or certified by the bankers, agreed with the balance shown in the merchant's books, would you consider any further examination necessary? State reasons for your reply. (C.P.A.)
81. In making a detailed audit, what procedure would you follow to verify the cash in transit to bank? (C.P.A.)
82. How would you verify the cash on hand and at bank at the date of the audit, for a company carrying balances at the head office, at several branches, and in the hands of foreign agents? (C.P.A.)
83. How should the bank balance appearing in the books of a company be verified by the auditor? (C.P.A.)
84. How would you verify the Cash Book balance of a company with deposits in Syracuse and New York under each of the following conditions:
    a. As of a present date
    b. As of a past date

85. If an audit is contracted for which calls for an examination of all vouchers of every description, what would you accept as proper vouchers for:
a. Cash receipts (C.P.A.)

86. If an audit is contracted for which calls for an examination of all vouchers of every description, what would you accept as proper vouchers for:
a. Cash payments (C.P.A.)

87. State what points you would observe in the auditing of vouchers covering disbursements. (C.P.A.)

88. What are the details to be considered in auditing vouchers for money disbursed? What is to be anticipated and guarded against? (C.P.A.)

89. In auditing cash payments, how would you prevent the reproduction and passing of vouchers a second time? (C.P.A.)

90. In the verification of cash on deposit, made in the course of a periodical audit, is it necessary to examine the returned canceled checks which were outstanding at the beginning of the period? Give reasons. (C.P.A.)

91. Do you consider it necessary, in auditing, to examine all paid bank checks? Give reasons. (C.P.A.)

92. You are called upon to audit the disbursements of a treasurer's account of a manufacturing company. The voucher system is in use. Five thousand vouchers are involved, these being paid by bank check which is attached to its voucher, or one of several it may have paid. You are expected to examine all vouchers, although a number of these may have been journalized.
State your method of procedure, also show how you know you have seen every voucher issued in the period under review. While this is going on, and may occupy some weeks in its discharge, office boys, clerks, manager, superintendents have access to the vouchers and are allowed to take out and return for reference purposes of their own at will. (C.P.A.)

93. How should the Petty Cash account be kept and audited? (C.P.A.)

94. You are required to make a detailed cash audit for three years ending October 31, 1923. You find a disbursement for "Rent October, 1920, $1,000.00," on November 6, 1920. You are told the receipt is missing and the duplicate cannot be obtained. You are shown as a voucher a check dated November 6, 1920, payable to the landlord or order for $1,000.00, indorsed with a rubber stamp and marked by the client's bankers "paid." State with your reasons whether you would accept this as sufficient evidence that the payment was made as recorded and, if not, what course you would adopt. (A.I.A.)

95. State how you would prove the correctness of the additions of the Cash Book without actually adding same. (C.P.A.)

96. A Cash Book exists with three columns on each side, viz.,
Debit side: discounts, cash receipts, bank;
Credit side: discounts, cash payments, bank.
In making an audit, you find that the cashier closed his Cash Book at the end of a month, bringing down a cash balance of $177.91; you count his cash and find that he has only $119.12. On going carefully through the month's transactions, you find that $45.37 paid in cash had been entered in the bank column; the total of a previous page of cash receipts, $2,516.25, was brought forward as $2,525.75; the discount, $2.50 on an account paid had been entered in the cash column as a payment instead of in the discount column; $10.00 received from a partner for payment of a private account had been included in the cash on hand, but not entered in the Cash Book.
Rule a form of Cash Book as above, enter the balance brought down, and make entries to correct the errors above described. Show the deficiency still existing, and state how it should be dealt with. (C.P.A.)

97. Given the following reconciliation of cash at the close of an audit, state categorically how it may be verified:

June 30, cash on hand as per Cash Book		$8,549.17
Balance as per bank Pass Book at the close of business	$16,549.72	
Add check of J. B. Jones, not deposited	1,450.00	
	$17,999.72	
Deduct checks drawn, not presented	10,154.29	
	$7,845.43	
Cash in drawer	703.74	$8,549.17

(C. P. A.)

98. Outline in the case of a Balance Sheet audit a program of instructions for verification of cash and bank balances. (A.I.A.)

99. Enumerate at least five causes, other than dishonesty, leading to a gradual decreasing bank balance, profits continuing normal. (C.P.A.)

Problems on Chapter V

Problem 13

On January 25, 1924, you commence an audit for the year ended December 31, 1923. The Pass Book was balanced as of January 25, 1924, the first time in three months, and showed a balance of $14,410.00. Check No. A107 for $100.00 and No. A110 for $42.00 have not been presented to the bank for payment. The petty cash is not operated upon the imprest basis, and there is $57.00 on hand as of January 25, as per your count. The petty cash disbursements from December 31, 1923, to January 25, 1924, amounted to $150.00, and during that time checks for $160.00 were issued for petty cash. During the period from December 31, 1923, to January 25, 1924, the following occurred:

Total deposits in the bank	$15,021.50
Exchange on above	25.00
Total checks drawn	6,240.00

Prepare statement showing the amount of cash on hand and on deposit as at December 31, 1923.

Problem 14

From the following data and such items as it may be necessary to supply:

a. Reconcile the checks issued and the canceled checks with the checks outstanding January 1 and March 31.
b. State the total of checks not entered on the Cash Book.

Cash Book

Balance, January 1, 1924	$ 6,820.17
Receipts, January 1 – March 31, 1924	18,467.29
Payments, January 1 – March 31, 1924	18,171.34

Check Book

Balance, January 1, 1924	$ 4,237.29
Deposits, January 1 – March 31, 1924	20,386.18
Checks Issued, January 1 – March 31, 1924	17,545.45

Bank Statement

Balance, January 1, 1924	$ 9,481.97
Deposits, January 1 – March 31, 1924	19,437.62
Canceled Vouchers, January 1 – March 31, 1924	20,763.85

(C. P. A.)

Problem 15

The Cash Book of a general trading concern shows for the month of January 1924, the following:

Receipts

1924			
Jan.	4	Collections from customers	$ 2,818.62
	7	do	1,147.33
	10	do	1,064.87
	12	do	1,232.55
	16	do	1,463.24
	23	do	2,417.14
	26	do	1,283.84
	29	do	1,543.62
	31	do	1,054.27
		Total receipts per Cash Book	$13,925.48

Disbursements

1924			
Jan.	1	Overdraft on bank	$ 10.32
	3	Sundry checks	2,153.27
	7	do	1,427.83
	11	do	926.84
	15	do	853.87
	19	do	428.32
	23	do	647.83
	29	do	2,437.38
	31	Balance as shown by Cash Book	5,029.82
			$13,925.48

Cash on hand undeposited amounted to $56.23.

A petty cash fund is operated on the imprest basis.

The books had been audited to December 31, 1923, and the fact established that the overdraft of $10.32 was correct, after all checks drawn had been presented and paid by the bank.

The deposits in the bank for the month of January, as shown by the bank Pass Book, after having it balanced at close of business January 31, amounted to $13,854.37, and the checks returned by the bank for the same period totaled $8,832.43.

There were checks outstanding at the time of balancing, January 31, amounting to $53.27.

Fraud is suspected on the part of the cashier, and you are asked to check the transactions recorded by him as shown by Cash Book.

Prepare a statement showing the result of your investigation. Also state with reasons, what further documents and records you would require, if any, to trace the cash transactions fully. (C.P.A.)

PROBLEM 16

Fraud is suspected on the part of the new cashier of the A Company and you are asked to check the transactions recorded by him as shown in the Cash Book for the month of September 1923. The Cash Book appears as follows:

RECEIPTS

Sept.	1	Collections from customers	$ 2,707.51
	3	do	2,101.01
	4	do	2,157.43
	6	do	1,846.78
	8	do	2,250.64
	11	do	2,213.18
	15	do	3,667.20
	18	do	2,038.48
	25	do	2,590.62
	29	do	2,252.63
			$23,487.09

DISBURSEMENTS

Sept.	1	Bank overdraft	$ 15.25
	3	Checks issued	4,635.72
	8	do	4,945.38
	15	do	3,780.71
	22	do	502.00
	29	do	4,583.21
	29	Balance per Cash Book	5,024.82
			$23,487.09

You are to assume that the overdraft on September 1, is correct.

The Bank Statement of October 1, shows that the deposits for the month of September amounted to $23,410.48, and the canceled checks for the month amounted to $14,249.22.

Cash not deposited amounts to $15.00, and checks outstanding total $4,636.48, on September 29. (C.P.A.)

QUESTIONS ON CHAPTER VI

100. Give either the classification of notes receivable suggested in the Federal Reserve Bulletin for April 1917, for use in audited statements, or an alternative classification. (A.I.A.)
101. As an auditor, how would you undertake to verify the asset of notes receivable? Would your procedure be any different if the company's sales were at least $500,000.00 a year? (C.P.A.)
102. As a feature of an audit made in March to cover the fiscal term ended December 31, previously, describe your method of proving notes receivable on hand as shown in the Balance Sheet of December 31. (C.P.A.)

103. What do you understand by the term "notes receivable discounted"? What entries are required in respect of notes receivable discounted? How should notes receivable under discount be shown upon a Balance Sheet, if at all? (C.P.A.)
104. What measures should be taken to ascertain whether or not any notes receivable have been discounted and cleared from the books, notwithstanding the fact that they are not due and at maturity will be subject to demand on the last indorser in case payment is defaulted by the maker? (C.P.A.)
105. In auditing the accounts of a firm you find a number of dishonored and overdue notes which form part of the balance of the Notes Receivable account. State fully what you would do with these. (C.P.A.)
106. A firm is indebted to one of its creditors in the sum of $45,000.00. The creditor agrees to accept notes with good indorsements for $50,000.00 in full settlement of the account, with the understanding that if any payment is not made at maturity, the whole debt, less such sum as may have been paid, shall be declared to be due by the creditor. After concluding this arrangement the firm is succeeded by a corporation.

    The agreement covering the turnover provides that all debts of the firm shall be paid by the corporation. Only the indorsed notes for $50,000.00 are brought into the books of the company, and nothing is said regarding the agreement hereinbefore referred to respecting the original debt. You are asked to certify to the accounts thus set up. What course would you pursue? (C.P.A.)
107. You are making the examination of a financial statement of a manufacturing company for credit purposes. Your letter of verification from the note broker disclosed the fact that notes aggregating $70,000.00, have been sold by him and the proceeds not remitted to your client until fifteen days after the closing of his books. These notes of $70,000.00 represent part of notes aggregating $100,000.00, which were sent to the note broker for discount one month prior to the date of closing, $30,000.00 of which have not been sold by the note broker. No entries have been made upon the books of your client for these transactions. The client claims that he has the right to offset the liability for the discounted notes with the proceeds

in the hands of his note broker, as these proceeds had not been remitted to him until after the closing of his books. State your opinion with regard to this contention. (C.P.A.)

108. What steps would you take to audit the Notes Receivable Purchased and the Notes Receivable on Commission held by a commercial paper house, to satisfy yourself that there had been no fraud by substitution? (C.P.A.)

109. Outline your method of procedure of auditing the notes receivable under:
a. Balance Sheet audit
b. Detailed audit

110. What points in an audit are to be observed in the verification of notes receivable held as securities? (C.P.A.)

111. Would you class as fixed assets or as current assets the stock or bonds held by a company and representing control of another? Give reasons.

112. State in detail how you would audit and verify the notes receivable of a large trading corporation with several affiliated concerns, giving due attention to collateral, notes discounted, makers, etc. (A.I.A.)

113. In auditing the accounts of a large corporation you find an account with X Bonds, charged with $200,000.00, representing the cost of bonds subscribed and paid for by the company. At the date of the Balance Sheet to which you are to certify, the bonds had a market value of $187,500.00. What attitude would you take as to their valuation in the Balance Sheet?

114. Under what circumstances would you permit a client to carry bonds at cost when the market is lower? (C.P.A.)

115. What would you consider a satisfactory voucher for: Investment in a mortgage? (A.I.A.)

116. State fully the treatment of bond investments in accounts.

117. State in detail the proper method of verifying securities owned which are carried as quick assets. (A.I.A.)

118. In auditing the books of a corporation you find record of the ownership of stocks and bonds, some of which are in hand, some are deposited with bankers or others for safekeeping, and others are lodged as security for loans. State what kind of evidence you would require in each case, specifying particularly in the case of stocks and registered bonds, if not registered in the name of the corporation, what you consider necessary to protect your client's interests. (A.I.A.)

119. What would you consider a satisfactory voucher for: Purchase of a Stock-Exchange security? (A.I.A.)

120. Where securities comprise the stock in trade of the client, state generally the points to which the auditor's attention should be directed, and the manner in which the verification would be made of the amount thereof shown in the Balance Sheet.

121. Your verification of the securities of a corporation has to be made at a date about two months subsequent to the date of the Balance Sheet you are asked to certify. Can you suggest steps which will enable you to do this without risk of overlooking serious misstatement? (A.I.A.)

122. In auditing the books and accounts of a concern after the books have been closed and the Balance Sheet and Profit and Loss Statement have been prepared, you find the following items included in the Profit and Loss Statement:

a. Increase in value of stocks held	$1,000.00
b. Profits from stocks and bonds sold	800.00

Criticize these items and, if erroneous, state how you would correct them. (C.P.A.)

123. In auditing a trust company's accounts, you find that the company is cotrustee for a number of estates. The securities are locked in a safe deposit box that cannot be opened without the assistance of the absent trustee, who will be away for several months. What precautions should be taken to safeguard the integrity of your audit? (C.P.A.)

124. If you are called upon to audit the accounts of a trust company or building and loan association whose principal investment may be mortgages, how would you prevent the introduction of canceled or fictitious mortgages? (C.P.A.)

125. Is the term "fund" ever used to designate an item on the credit side of a Balance Sheet? What do you consider to be the usual purpose of a sinking fund?

126. In what manner should the auditor verify the existence of sinking fund assets?

127. On March 15, 19—, you received instructions to audit the accounts of a large corporation whose fiscal year ended on the preceding December 31. The corporation has subscribed for certain bonds through various banks and at this December 31, certain subscriptions had been paid for in full by employees and delivery of bonds accepted, while in other cases part pay-

ments only had been made. Bonds have also been delivered to the company upon fully paid subscriptions. Describe how you would proceed to verify the asset shown in the Balance Sheet at December 31, representing bonds on hand and part payments made on subscriptions, so that you can give an unqualified certificate to your clients as of this December 31. (A.I.A., adapted)

128. How would you disclose on a Balance Sheet dated December 31, bonds put up as collateral when there is a strong probability of their not being released? (C.P.A.)

Problems on Chapter VI

Problem 17

Previous to examining the accounts of a corporation at the end of its first fiscal year, you find that the notes receivable stand in the financial statement prepared for the banker at $5,500.00.

Upon investigation, it is disclosed that $20,000.00 of notes from customers were received during the period, and that $10,000.00 of these notes were duly paid in full by the customers to the company at maturity, and $5,000.00 were discounted at the bank. Of the notes discounted, a note for $500.00, given by Brown & Company, was not paid when due, and has been charged back to the Notes Receivable account. Notes to the amount of $1,500.00 are not yet due at the bank.

Partial payments have been made to the company to the extent of $500.00 on notes still due and these payments have been credited to an account called Partial Payments on Notes Receivable. This item is listed in the financial statement as a liability.

A customer's note of $1,000.00 is found to have been given as collateral for the payment of a note of the company discounted at the bank.

A 30-day note given by an officer of the company for $200.00 is treated as a cash item. The note is 60 days past due.

You are asked to give the Journal entry or entries for obtaining the proper account or accounts to record the above facts, and to give such comments as you would consider appropriate to include in your report relative to these items. (C.P.A.)

Problem 18

The accounting firm of C. P. & A. employs you as a senior accountant, and for your initial job requires you to draft the accounts related to

Notes Receivable from memoranda shown in a client's diary, the client being an export broker, as follows:

1924			
Jan.	2	Took G. D.'s note, 90 days' settlement of account . . .	$ 600.00
	3	Accepted M. O.'s 30-day draft, documents attached for goods shipped me from Paris	1,945.00
	4	Received from Bank of Havana, 60-day draft for proceeds of accounts collected by them	425.00
	24	Received from B. A. note at 30 days on settlement of account	650.00
	25	Drew on C. M. 15 days from date for account of goods shipped to London	350.00
	26	Accepted L. H.'s draft, 60 days' sight	750.00
	28	Received C. M.'s draft, accepted January 26	350.00
	29	Discounted G. D.'s note at bank, received	591.25
Feb.	5	Paid M. O. draft	
	10	Discounted Bank of Havana draft, received	411.65
	11	C. M. draft returned	
	26	B. A. note paid	

(C. P. A., adapted)

Problem 19

The trustees of an estate of $250,000.00, make the following investments and collect the income:

Purchases

1923		
Feb.	2	100 shares XD stock, par $100.00 @ $109.50
Mar.	5	10 O.K. bonds maturing 1966, $1,000.00 each, 6%, January 1 and July 1, @ $1,010.00 and accrued interest
April	10	Bond and mortgage for $5,000.00, maturing 1928; interest 5%, April 1 and October 1
Oct.	6	10 O.K. bonds maturing 1966, $1,000.00 each, 6% January 1 and July 1, @ $1,020.00 and accrued interest

Sales

1923		
Oct.	5	100 shares XD stock, par $100.00, @ $110.00. The XD stock paid quarterly dividends as under: April 1, $1\frac{1}{4}$%; July 1, $1\frac{1}{2}$%; Oct. 1, 2%. These dividends are received respectively on April 3, July 5, and October 3.

The interest on O. K. bonds is received July 2, and the interest on the bond and mortgage for 5 months and 20 days is received on the date due.

On April 10, the trustees borrow from the bank, $1,100.00 on a collateral note and repay the loan on October 10, with interest at 6% per annum.

Prepare auditor's Trial Balance as of October 10, 1923, indicating accounts related to each security. (C.P.A., adapted)

PROBLEM 20

The following are the transactions of a certain Securities Company for the period of one year, January 1, to December 31, 19—. With these as a basis, prepare Balance Sheet and Statement of Profit and Loss.

Jan.	1	Cash capital paid in, for which stock issued $2,000,000.00.
	1	Purchased 400 shares A. B. Co. stock @ $103\frac{3}{4}$ plus $\frac{1}{8}$.
	1	Purchased 100M C. D. Co. 6's @ 112 plus $\frac{1}{8}$. Interest payable J. & J. Life $17\frac{1}{2}$ years.
	23	Purchased entire issue of stock of H. K. Co. (4,000 shares) @ 105.
April	30	Sold 20M C. D. Co. 6's @ 114 less $\frac{1}{8}$, and accrued interest $400.00.
July	1	Purchased 100M N. P. Co. 4's @ $99,585.06 plus brokerage $\frac{1}{8}$. Interest payable J. & J. Purchase to yield 4.85%. Life 6 months. Consider brokerage as an expense.
	1	Purchased entire issue of stock of R. S. Co. (10,000 shares) @ 112 plus $\frac{1}{8}$.
	1	Purchased entire issue of stock of W. X. Co. (1,000 shares) @ $78\frac{1}{2}$ plus $\frac{1}{8}$.
Aug.	15	Stock dividend received on A. B. Co. stock, 5%.
	31	Sold 20M N. P. Co. 4's @ 98 less $\frac{1}{8}$, and accrued interest, $133.34.
Sept.	15	Cash dividend received from H. K. Co., 5%.
Nov.	15	Cash dividend received from R. S. Co., 9%.

The yield on C. D. Co. 6's is 4.95% on a cost of $112,197.30.

Balance Sheets as on 12/31 of companies whose stock is held show:

a. H. K. Co.	Surplus	$100,000.00
b. R. S. Co.	Surplus	270,514.84
c. W. X. Co	Deficit	25,076.52

QUESTIONS ON CHAPTER VII

129. Mention three classes of transactions which a debit item may represent in a customer's account. (A.I.A.)
130. Properly, what should be included under the heading of "accounts receivable" upon a Balance Sheet?
131. The bookkeepers of the Jacksonville Mercantile Co. find that accounts receivable as taken from the Ledgers amount to $14.50 more than the balance shown by the controlling account. There are 5,000 open accounts. The bookkeepers have been checking back for weeks in the effort to locate the difference, but have given up in despair. You are engaged to locate it. Formulate your plans. (C.P.A.)

132. Indicate what would guide you in examining and criticizing accounts receivable carried on the branch office books of a business. What would you require before:
    a. Accepting the debits as good, or
    b. Writing off those you were told were bad? (A.I.A.)
133. A firm having several branches maintains in its Ledger an account with each branch, and charges to such account all goods sold to the agent for stock, accounts receivable arising from sales by the branch within its territory, and cash collected by the branch.
    At the end of the year, the balance of each branch is treated as an ordinary account receivable and is included in the general debts due to the firm. In certifying the accuracy of the firm's Balance Sheet, would you pass such accounts receivable? If not, state what objections there are to this method and how you would deal with the accounts. (C.P.A.)
134. As an auditor, to what extent would you charge yourself with responsibility for the accuracy, both as to facts and figures, of accounts receivable — trade, personal, consignment? (C.P.A.)
135. Included among the accounts receivable are the following items:
    a. Bad debt suspense
    b. President's drawing account
    c. Consignment stocks
    d. Working fund
    Do you consider that these items have been classified properly? Indicate reasons.
136. In auditing the accounts of an engineering corporation, you find a number of engines have been shipped to dealers on consignment, against which the dealers have made deposits of 75% of the invoice price. The engines were invoiced out to the dealers at the regular contract prices, being carried in the accounts receivable, the deposits referred to being credited to the same accounts. In drawing the Balance Sheet, how would you consider these items should be stated, and on what basis of valuation? (C.P.A.)
137. The audit of a corporation, on the instructions of its president, reveals the following condition:

ASSETS

Real estate, plant, and machinery	$500,000	
Merchandise of all kinds	200,000	
Notes receivable	50,000	
Accounts receivable	275,000	
Sundries accrued	4,500	
Cash	37,500	$1,067,000

LESS LIABILITIES

Notes payable	$250,000	
Accounts payable	40,000	290,000
Net resources		$777,000

The capital of the corporation is $1,000,000, with deficit of $223,000. The audit brings out the fact that included in the accounts receivable is an item of approximately $50,000, due by the president of the company. In certifying to the Balance Sheet, the president requests you not to show as a separate item the amount due by him, but to include it as shown above in the accounts receivable for the reason, you are informed, that your certificate is to be used for the purpose of selling $250,000 bonds secured by mortgage on the real estate, plant, and machinery, the proceeds of which will be used to liquidate the present notes payable. The president of the company is reported to be worth $200,000 over and above the value of his stock in the above company.

What course of action would you take? State the reasons therefor. If the certificate was stated to be for the purpose of handing the certified Balance Sheet to their bankers or to present to the annual meeting of stockholders, then what would be your course of action and why? (C.P.A.)

138. Explain how you would deal with advances on contracts of purchase.

139. A corporation has a controlling account in the General Ledger for accounts receivable. The balance of the controlling account is $80,000. The debit balances of the individual accounts total $100,000, and the credit balances total $20,000. Is a statement correct which uses the controlling account balance as an asset? If not, what would you do? Give reasons. (C.P.A.)

140. In preparing a Balance Sheet, what basis would you use to ascertain that the asset of accounts receivable was valued properly:
a. In general *b*. Completely

141. Explain in full your method of arriving at a correct allowance for bad debts. (C.P.A.)

142. If on a second audit, made a year after the first one, you find that many of the same items of bad and doubtful debts to which you drew attention at the earlier date still remain unchanged, what action would you take? (C.P.A.)

143. How should an auditor undertake to verify bad debts written off?

144. How should a reserve for cash discounts on outstanding accounts receivable be computed? When would you advise setting up such a reserve? (C.P.A.)

145. What inference would you draw from an account which showed a partial payment on an old invoice and complete payments on invoices of later date?
Of what use would be a compilation of percentages covering gross and net sales, in relation to outstanding accounts?

146. In the course of an annual examination as of December 31, you find the following, in the Customers' Ledger.

WINSLOW & COMPANY

19 —			19 —		
July 1	Mdse.	50.00	Aug. 20	Cash & Disct.	50.00
Aug. 3	Mdse.	60.00	Oct. 3	Do	75.00
Sept. 15	Mdse.	75.00	Dec. 1	Do	100.00
Oct. 10	Mdse.	100.00	Dec. 31	Balance	60.00
		285.00			285.00
Dec. 31	Balance	60.00			

What are your views on the above? (C.P.A.)

147. As an auditor, how would you satisfy yourself concerning the following:
a. Allowances to customers for returned *goods*
b. Sales to customers

148. As an auditor, how would *you* undertake to verify the asset of customers' accounts? Would your procedure be any different if the company's year's sales were at least $500,000 a year? (C.P.A.)

149. Outline your method of procedure of auditing the accounts receivable under:
a. Balance Sheet audit
b. Detailed audit (C.P.A.)

Problems on Chapter VII

Problem 21

In course of an audit as of June 30, 1924, of a jobbing dry-goods concern, you find an account with a customer as follows:

1924				1924			
Jan.	1	Balance	$4,170.00	Jan. 20		Notes Rec., 4 mo.	$1,670.00
Feb.	22	Notes Rec.	2,500.00	Feb. 20		Cash	500.00
Mar.	31	Mdse.	1,400.00	Feb. 20		Notes Rec., 3 mo.	2,000.00
May	22	Notes Rec.	2,000.00	Apr. 20		Notes Rec., 4 mo.	1,400.00
May	23	Notes Rec. and Expense	1,675.00	May 20		Cash	500.00
				May 20		Notes Rec., 3 mo.	1,500.00
June	30	Mdse.	950.00	June 30		Balance	5,125.00
			$12,695.00				$12,695.00
June	30	Balance	$5,125.00				

Prepare analysis of this account.
Indicate Balance Sheet set-out.
Indicate reasons for treatment. (C.P.A., adapted)

Problem 22

The Trial Balance of a Manufacturing Company which you are auditing as of December 31, 19—, shows:

Accounts Receivable	$369,926.00
Allowance for Doubtful Accounts	2,608.00

The schedule of the accounts receivable furnished the auditor by the office accountant was checked with the Ledgers with the following results:

1.	45 accounts with credit balances totaling		$9,820.64
	City Ledgers (card):		
	A — C	$2,340.16	
	D — I	495.82	
	J — R	1,762.18	
	S — Z	2,486.93	
	Country Ledger	2,735.55	
2.	Total of all accounts with debit balances		379,744.34
	City Ledgers (card):		
	A — C	$80,126.32	
	D — I	86,903.17	
	J — R	78,440.29	
	S — Z	93,507.86	
	Country Ledger	40,766.70	

Further, the examination of the accounts disclosed the following:

1.	Special account of President, H. C. Doolittle	$30,000.00
2.	Due from employees on stock subscriptions	3,150.00
3.	Consignment accounts (credit to Sales)	19,500.00
4.	Interest receivable on one account, of P. D. Seymour & Sons ($15,000.00), 3 mo. @ 6%	225.00
5.	Balance, trade debtors (includes $15,000.00 in 4)	

The accounts overdue were divided into lists as under:

1.	Less than 30 days past due		$56,992.60
2.	30–60 days past due		68,414.10
	City	$28,702.18	
	Country	39,711.92	
3.	60 days — 6 mo. past due		49,727.25
	City	$13,846.93	
	Country	35,880.32	
4.	6 mo. — 1 year past due		7,830.75
	City	$5,353.45	
	Country	2,477.30	
5.	Over 1 year past due		18,641.20
	City	$14,201.10	
	Country	4,440.10	

Product is sold n/30. No trade discounts to be considered. The Allowance for Doubtful Accounts has not been disturbed during the past 18 months. No accounts were charged off during the year. No accounts were hypothecated or assigned. Credit balances represent overpayments, allowances or goods returned, and claims allowed. No confirmation verification is possible. Credit man insists actual losses will not exceed $2\frac{1}{2}\%$.

Required: Whatever schedules, adjustments, and recommendations appear necessary in the premises.

Problem 23

On June 1, 1924, Wm. Smith bought a small manufacturing business for a cash consideration of $25,000.00. He received the following assets free and clear of all liabilities:

Machinery which cost $15,000.00, and which was considered as worth $12,000.00; lumber which cost $5,000.00, and which would be worth $6,000.00 at the market prices then prevailing.

Other raw material which was worth $2,000.00 at cost and at market.

Mr. Smith was not to receive any interest in the accounts receivable (which had a total face value of $8,000.00) but as an accommodation, he undertook to collect them for the former owners, and by agreement he was to make an accounting to them on August 1, 1924.

Between June 1 and August 1, 1924, no regular books of account

were kept, and at the latter date Mr. Smith asks you to open a simple set of books which will record the totals of his transactions to date. He also asks you to prepare a Balance Sheet and a statement to be submitted to the former owners.

He is able to supply you with the following information from memoranda he has kept:

Cash collections, on old accounts receivable	$6,500.00
On new accounts receivable	6,000.00
Cash disbursements, wages	2,000.00
Other factory expenses	300.00
Paid former owners, on account	3,000.00
Collection expenses on old accounts	50.00
Material purchases	6,000.00
Open items at August 1, 1924:	
Old accounts receivable uncollected	1,350.00
New accounts receivable uncollected	6,925.00
Factory expenses unpaid	125.00
Material bills unpaid	1,700.00
Cash on hand, August 1, 1924	725.00
Material on hand, August 1, 1924, at market, $4,800; cost	5,500.00

From the above information prepare Journal entries necessary to record the transactions to date and a Balance Sheet at August 1, 1924. (C.P.A.)

Problem 24

The General Ledger Trial Balance of the Monican Company as of December 31, 19—, contains the following item:

Accounts Receivable, Consignment	$13,547.07

A listing of the Consignment Ledger balances at the same date produces the following:

	Debits	Credits
Anton & Co., Inventory Account	$25,739.06	
Anton & Co., Finance Account		$10,197.87
Jones & Co., Inventory Account	483.89	
Jones & Co., Finance Account	1,624.84	
Dunn & Co., Inventory Account		5,394.84
Dunn & Co., Finance Account	1,101.71	
Hardy & Co., Inventory Account	190.28	
	$29,139.78	$15,592.71

The inventories of goods out on consignment, taken from the inventory sheets received, were as follows:

Anton & Co.	$18,664.09
Jones & Co.	133.35
Dunn & Co.	4,603.65
Hardy & Co.	190.28

These inventory items, upon examination, were found to be correct as to amounts. The inventory of goods at the mill was $32.086.26.

Prepare reconciliation, adjustments and Balance Sheet set-out for the above, as of December 31, 19—.

Questions on Chapter VIII

150. As an auditor, what documentary evidence would you require in support of expenditures for merchandise purchases?

151. What safeguards in accounting would you suggest to a client to prevent loss of stock by theft? (C.P.A.)

152. Should inventories of a manufacturing concern be taken at cost value, at market value, or at some other value? Give reasons. (C.P.A.)

153. It is generally conceded that merchandise inventories should be calculated on "cost" prices, but in practice there are found many differences in the method of determining the cost price. State whether or not the following items should be regarded in arriving at cost, giving your reason in each case:

Cash Discounts	Rebates and premiums, such as are found in the tobacco business
Trade discounts	Drayage and handling (inward)
Freight inward (on goods bought)	Packing and draying (outward)
Freight outward (on goods sold)	

(C.P.A.)

154. In auditing the accounts of the Barclay Manufacturing Company, it is ascertained that, owing to business depression, there was an abnormal drop in the market value of the inventories at the close of the fiscal year, to the end that the market value of the stock on hand was $50,000.00 less than the cost value. The company has prepared its Balance Sheet, stating therein the inventories at cost, and wishes it to be published in that form subject to the comments of the auditor thereon.
As auditor, draft your comments relative to inventories in the form in which they will be printed as part of your certificate.

155. In passing upon the value shown in the inventory, how should the auditor treat materials costing $10.00 per unit when the market price is $8.00 per unit, and when the market price is $12.00 per unit? State reasons fully. (C.P.A.)

156. In making an audit, what are the important points to be considered in connection with an inventory? Why are they important? (C.P.A.)

157. As an auditor, to what extent would you charge yourself with responsibility for the accuracy, both as to facts and figures, of

the following: Inventories — manufactured, in process — merchandise, supplies?

158. Would you examine the inventory of a firm, in view of the fact that the auditor is not responsible for the inventory? If so, why? If not, why not? (C.P.A.)

159. When an inventory is not made under your personal supervision, what procedure would you deem necessary to protect your certification of the audit? (C.P.A.)

160. An auditor is required to certify to the correctness and value of an inventory with which he is unfamiliar. Should he decline to do so? Give reasons. (C.P.A.)

161. Can an examining accountant satisfy himself of the general correctness of inventories without himself taking the quantities and verifying the prices, extensions, and additions? Give full particulars. (C.P.A.)

162. Describe what you consider the correct attitude of an auditor regarding inventories generally, and especially when preparing a Balance Sheet for a bank:

Real estate company
Wholesale grocer
Orange grove
Steamboat company (C.P.A.)

163. Describe a perpetual inventory, its advantages and disadvantages:

1. In general
2. As applied to:
   a. Real estate company
   b. Wholesale grocer
   c. Orange grove
   d. Steamboat company

Discuss the above especially as to:

1. Current information
2. Use in preparation of interim statements
3. Use in preparation of periodical statements (C.P.A.)

164. What is turnover, and what use should an auditor make of it in an audit of a merchandising business? (C.P.A.)

165. A manufacturing concern finds that in the past operating year the manufacturing profit was thirty-four per cent of the profit on sales. On June 30, of the current year, the directors want an approximate inventory without count or schedule and call upon you to produce it. Illustrate your plan of procedure.

166. Indicate in what circumstances and for what purposes you would consider a book inventory to be of use in a manufacturing business:

1. For current information
2. For use in the preparation of interim statements
3. For use in the preparation of final yearly or half-yearly accounts

Assuming your client decided to rely upon such book records, what steps should be taken to guard their accuracy? (A.I.A.)

167. What safeguards would you employ as an auditor of a manufacturing company as concerns the valuation of inventories?

168. On what basis should an inventory of a car builder company be prepared? Deal specifically with the following classes of material:

1. Lumber purchased from a sawmill in "green" state
2. Cars under construction — four-fifths completed:
   a. When \$1,000.00 per car will be lost on completion of contract
   b. When \$1,000.00 per car profit will be realized
3. Castings manufactured by the company (C.P.A.)

169. In the course of an audit of a stove manufacturer's books, as of March 31, you notice that three invoices respectively for pig iron, sand, and fire brick, dated on the 22, 27, and 28, of that month of March, were entered in the books in the following April. What does this signify and how may it affect your report? (C.P.A.)

170. In the examination of the accounts of an important railroad, it appears that none of the invoices and material purchased appear on the company's books until they have been approved by the Purchasing Agent and division superintendents, although the various storekeepers' reports show that much of the material and supplies actually has been received. How would you deal with such a condition and determine the real position of the railroad with respect to purchases not taken up on the Voucher Register?

171. In an audit covering the year ended December 31, you discover that invoices aggregating \$2,000.00 for bricks and other building materials to be used in the construction of an addition to the plant, were received after the books were closed,

although the materials actually were received on December 15. As the materials were not taken into the inventory, and the invoices were not on the books, would you recommend any adjustment? Give reasons. (C.P.A.)

172. An investigation of the details of an inventory dated January 1, 19—, brings to light the following entry:

Contract dated July 1, of the preceding year, for delivery of 20,000 tons of .... between January 1 and June 30, of this year, at $25.00 per ton, the market price at date of inventory being $27.50 — $50,000.00.

Discuss the validity of the above entry under the following circumstances:

a. In the preparation of a certified Balance Sheet for stockholders' meetings
b. In investigation on behalf of a client who is considering the purchase of the majority of the capital stock of the company
c. In investigation and preparation of a certified Balance Sheet for the company (the company being your clients) which they desire to submit to their bankers (C.P.A.)

173. What is your understanding of "work in progress"?
174. State whether depreciation is an element of the cost of manufactured products. If so, why? (C.P.A.)
175. As a certified public accountant auditing the books of a manufacturing business that operated a supposedly highly developed cost system, what steps would you take regarding inventory values that were found to agree with the cost records? (C.P.A.)
176. A small firm is engaged in the business of hat manufacturing. The accounts do not embrace a cost system, although one could readily be installed, as the labor is on a piece-work basis and the goods manufactured are standard, requiring a given quantity of braid, thread, etc., per dozen.
The firm closed its books showing a loss of $10,000.00 for the year, the inventory, which aggregated $45,000.00, being taken by actual count and priced at estimated cost. You were engaged to audit the accounts, and during the progress of your audit the firm informed you that $8,000.00 worth of finished goods had been omitted from the inventory, giving you the case numbers. What steps would you take to verify the adjusted inventory? (C.P.A.)

177. Is there any objection to the plan of inventorying finished goods at selling price less an estimated cost of delivery and other similar charges?
178. What steps should an auditor take in the verification of inventories of finished products?
179. The value of a certain inventory of finished product on hand at December 31, 19—, is as follows:

Materials	$193,000.75
Direct labor	98,111.32
Plant overhead (100% of direct labor)	98,111.32
Total	$389,223.39

The actual factory expenses amounted to 120% of the productive labor for the year. Discuss whether or not this inventory has been valued properly.

180. You are auditing the accounts of the A. B. C. Paper Co., of St. Louis, at October 31, 19—, and you find that the entire output of paper is sold under contract to Smith & Co., of Kansas City, at $43.00 per ton f.o.b. Kansas City, deliveries being made upon order of purchaser.
This price of $43.00 per ton is made up of the following component parts:

Cost of manufacture, including overhead		$25.00
Selling and administration expenses		1.00
Freight — St. Louis to Kansas City	$3.00	
Expenses of delivery to railroad	.50	3.50
Profit to A. B. C. Company		13.50
Total		$43.00

At what figure would you permit the A. B. C. Co. to inventory the paper on hand at the date of your examination? Please give full explanation in support of your answer. (C.P.A.)

181. After taking an inventory of the finished goods of a concern, it was found that all were not on hand that should have been. Select some business with which you are familiar, and state what steps you would take to account for the discrepancy. (C.P.A.)
182. What is meant by an "inventory adjustment" account? Indicate its use and what happens to the balance therein at the end of a fiscal period.
183. In making an examination of the accounts of a manufacturing concern for a period of five years, you suspect that one of the

inventories has been inflated. How would you proceed to verify this?

184. When auditing the accounts of a wholesale grocery house, it is found that a fire has just destroyed the entire stock of merchandise. What course would you follow to approximate the inventory? (C.P.A.)

185. You are engaged to audit the accounts of the X Company, manufacturers of hosiery — this company operating four mills, the product of which consists of numerous grades and styles. The company is without a cost system, but endeavors to ascertain its costs by taking the estimated quantities of cotton or silk to which is added a labor cost determined by tests, and to the total thus obtained an arbitrary percentage is added to cover general expenses, etc.

The general books consist of a Ledger, Cash Book, Journal, and Voucher Record. Invoices are entered after approval and have stamped thereon the date of approval. The receiving record consists of loose memoranda in pencil containing the name of the party from whom materials were received and the number of cases, but no further details.

Give full particulars as to the steps you would take to verify the inventory. (C.P.A.)

186. To what extent, and in what manner, would you verify the inventory:

1. In a Balance Sheet audit
2. In a detailed audit (C.P.A.)

Problems on Chapter VIII

Problem 25

In checking the inventory sheets and Ledger accounts dealing with materials, you found that the following errors had occurred:

December 31, 1922. An item of $500.00 was added to inventory sheet after totals had been obtained and was not entered in the Ledger account.

December 31, 1922. An error of $1,000.00 in adding the inventory extensions resulted in an overstatement of the inventory by this amount.

December 31, 1923. An error is made in valuing one lot of material, the result of which is an overstatement of the inventory value to the amount of $2,000.00.

December 31, 1923. An error of $10,000.00 in footing the inventory extensions resulted in an understatement of the Ledger inventory by this amount.

December 31, 1923. An invoice of $4,000.00 for materials just received included in accounts payable but the amount was not included in the inventory.

You are asked to draft the necessary Journal entry or entries to correct these errors, and to show the net effect of the errors upon the profits of each of the two years. Assume that the profits shown on the Ledger for 1922 were $20,000.00, and for 1923, $30,000.00. (C.P.A.)

Problem 26

The following particulars are extracted from the statistical records of a corporation:

	Turnover	Average Stock	No. of Times Turned Over
1921	$ 500,000.00	$ 50,000.00	10
1922	900,000.00	100,000.00	9
1923	1,000,000.00	125,000.00	8

To what conclusions do these figures point? (C.P.A.)

Problem 27

The board of directors of the X.Y.Z. Company removed their manager on April 30, 1924, on the general suspicion that his books misrepresented the true financial condition of the business. Prepare a statement showing the nature and probable extent of the misrepresentation.

The following is a Trial Balance taken from the books on April 30, 1924:

Capital stock		$75,000.00
Fixtures	$ 10,000.00	
Inventory, January 1, 1924	128,600.00	
Cash	15,450.00	
Accounts receivable	24,600.00	
Accounts payable		39,000.00
Loans payable		10,000.00
Sales		51,000.00
Purchases	40,700.00	
Salaries, Salesmen	2,200.00	
Advertising	1,650.00	
Salaries, office	1,100.00	
Rent	400.00	
Interest	200.00	
Insurance, January 1 to December 31, 1924	999.00	
Stationery and printing	105.00	
Reserve for depreciation of fixtures		2,710.00
Surplus, January 1, 1924		48,294.00
	$226,004.00	$226,004.00

An analysis of the Purchases and Sales accounts revealed the following: Purchases, year 1921, $122,000.00; sales, year 1921, $153,750.00; inventory, January 1, 1921, $101,000.00; purchases, year 1922, $123,000.00; sales, year 1922, $153,170.00; inventory, January 1, 1922, $100,000.00; purchases, year 1923, $121,000.00; sales, year 1923, $154,722.00; inventory, January 1, 1923, $102,000.00. (C.P.A., adapted)

Problem 28

John Adams lost his stock of merchandise, May 1, 1924, through a flood in the Mississippi River.

Adams applied to the local Mutual Flood Insurance Society for reimbursements, claiming a loss of $5,886.35, on merchandise stock. From the following data, ascertain his merchandise inventory:

Net profits, May 1, 1924, $4,452.91; drawings, $1,598.00; legal expenses, $17.50; interest debit, $313.00; advertising, $14.00; commissions, debit, $961.01; insurance, $196.23; sales, $81,688.04; inventory, December, 1923, $1,568.62; purchases, $55,415.82; labor, productive, $19,499.58; telephone, $416.06; sundry factory expenses, $3,201.92; repairs, $16.00; surplus, May 1, 1924, $2,854.91. (C.P.A.)

Questions on Chapter IX

187. Define the term "fixed assets." How should fixed assets be valued?
188. Give your views as to the better way of carrying property accounts in a manufacturing business, whether at cost or market value. (C.P.A.)
189. Outline the auditor's duty and responsibility in connection with the valuation of fixed assets. Does real estate require any special attention? Discuss.
190. What evidence should be required as to the correctness of values of assets (other than customers' accounts) entered in the books? (C.P.A.)
191. If you were employed to make an audit for the period of one year, what verification would you make of the fixed assets of the company which had been purchased several years previously? (C.P.A.)
192. As to the Real Estate account:

    a. Describe functions fully.
    b. Indicate entries to be made on each side.
    c. Show disposition of balance. (C.P.A.)

193. In auditing the accounts of a copartnership, you find the Real Estate account includes two pieces of property, the titles of which stand in the names of individual partners. What position would you take in regard to such items? (A.I.A.)
194. As to the Plant account:

    a. Explain meaning and use thereof.
    b. Indicate entries therein.
    c. Show disposition of balance. (C.P.A.).

195. As to plant additions:

    a. Specify the best method of carrying same on the books of a manufacturing concern.
    b. Indicate steps to be taken in auditing payments therefor in a manufacturing enterprise.
    c. What evidence would you consider satisfactory as establishing correctness thereof? (C.P.A.)

196. When Plant and Deferred Asset accounts are increasing, should an auditor attempt to ascertain whether or not production is increasing to the same relative extent? Discuss. (A.I.A.)
197. State briefly what you would do if included in the item of "Real Estate, Plant and Equipment" is the sum of $25,000.00 representing the cost of certain improved real estate, with interest and taxes thereon, which the company had purchased seven years previous for the purpose of building a branch factory, which project had been abandoned. (C.P.A.)
198. As to the asset of land:

    a. What general rule of valuation applies for Balance Sheet purposes?
    b. What rule of valuation applies when used for a factory site?
    c. What rule of valuation applies when purchased as an investment? (C.P.A.)

199. What means should be employed to verify the value of unimproved real estate? (C.P.A.)
200. Under what conditions may land values be appreciated in the accounts? (C.P.A.)
201. A concern owns a parcel of land which cost $500,000.00. There is a purchase money obligation on it of $350,000.00. You are asked to enter this land item in the Balance Sheet as $150,000.00, net. Would you comply with this request? Give reasons for answer.
202. What would you consider satisfactory evidence of the cor-

rectness and propriety of expenditures of land purchased? (A.I.A.)

203. How would you verify the Land account in making a Balance Sheet audit?

204. A firm carries on its books a number of parcels of land. By what means could the auditor satisfy himself as to the ownership and value of the several parcels? (C.P.A.)

205. How should a leasehold be treated in the accounts of a company and how should it be shown on the Balance Sheet?

206. State the proper procedure of an auditor in the verification of the Mines account.

207. What rule of valuation applies to land when purchased for subdivision and sale?

208. A real estate company for the purpose of obtaining cash to be used in developing a large tract of land assigns the mortgages, taken in part payment of land sold, to a trust company as trustee, whereupon the trust company delivers bonds to the real estate company which are then sold to the general public. You are called in to examine the books of the real estate company, and discover an apparent sale of land has been made to a syndicate, the members of which are directors of the company. Payment for the land sold to the syndicate was made by means of notes and mortgages of the syndicate. The mortgages were delivered to the trustee, bonds received and sold for cash. The minute books contain an agreement with the syndicate members to repurchase the land from the syndicate at the price paid by the syndicate therefor. How would you treat this transaction in preparing the Balance Sheet of the real estate company and what comments, if any, would you make in your report? (C.P.A.)

209. What method should an auditor employ in determining the value of buildings? (C.P.A.)

210. State in detail what steps you would consider necessary to verify the Buildings account. (C.P.A.)

211. If in auditing the accounts of a power company you found included in with other revenues an amount covering a charge to contractors for estimated loss on account of delay in completing new buildings, would you consider it a proper entry and what would be your duty under the circumstances? (C.P.A.)

212. A manufacturing company owns buildings in another city, that have not been used for business purposes for years. Indicate how you would show:

a. The property in the Balance Sheet
b. The expenses and taxes thereon in the Profit and Loss Statement (C.P.A.)

213. Of what value are insurance policies in determining the existence of liens or encumbrances?

214. Define the nature of the items properly chargeable to Construction account, after a mill has been in operation for five years. (C.P.A.)

215. In auditing the accounts of a manufacturing corporation, you find that the company has expended a total of $3,000.00 worth of its own materials, labor, and expense in constructing a machine for its own use. This machine, if bought in the open market, would have cost $4,000.00. Is it sound accounting to capitalize this machine at the market price? Why? (C.P.A.)

216. Under what circumstances would you permit a client to charge a compromise of a damage claim to Construction account? (C.P.A.)

217. Give some principles to determine a proper disposition of the cost of enlarging a plant, including a partial rebuilding of the old portion. In case you have insufficient data to enable you to apply these principles satisfactorily, offer some solution of the difficulty. (A.I.A.)

218. A corporation has sold its first mortgage bonds at a premium and its second mortgage bonds at a discount. As the auditor, how would you recommend that the premium and discount be handled on the books?

219. In the construction of a large building the proprietors issue $800,000.00 20-year 6 per cent bonds which are disposed of to the contractors at 85 per cent of their face value. It is contemplated that the discount of 15 per cent should be charged to Construction account in the first place, and then into Building account.

Is this procedure proper or not? Explain.

220. A company organized with $1,000,000.00 capital stock which it placed at par, and $1,000,000.00 of 5 per cent bonds which it sold at 90, this being a 6 per cent basis. It paid to contractors, etc., for construction $1,800,000.00 and this amount of investment ran, on the average, for one year before the property was ready for operation. When operation began the company had therefore paid one year's interest on the issue of the bonds. No dividends were paid on the stock. In

addition to the sum named above the company also paid $10,000.00 for legal expenses in connection with incorporation and $5,000.00 for franchise and other fees.

How should the accounts appear when the property was ready for operation? (A.I.A.)

221. How would you treat the Losses on Sale of Capital Assets in the Balance Sheet you were auditing? (C.P.A.)

222. Define:

a. Appreciation
b. Appraisal
c. Going concern

223. How should a reappraisal of capital assets be treated on the books of a going concern:

a. When it involves appreciation
b. When it involves depreciation (A.I.A.)

224. The A Company had an appraisal made early in January and after completing the annual audit for the A Company, the directors authorize you to record upon the books the proper values as given in the appraisal. Among the terms used in the appraisal company's report are the following:

a. Sound value
b. Depreciated value
c. Replacement value
d. Insurable value
e. Book value

Define each of these terms and state definitely just what values it would be proper to record upon the books. What adjustment account or accounts would be used in the work and what disposition should be made of any balances remaining in such account or accounts? (C.P.A.)

225. If an appraisal by a recognized appraisal company or engineer is furnished you on the properties, machinery, franchise, etc., of a client, which does not accord entirely with your views, would you accept figures shown by the appraisers, or endeavor to establish your own in making up a statement of condition at the date of appraisal? Why? (C.P.A.)

226. A certain corporation, under over-conservative management, had for years failed properly to capitalize many internal improvements and additions to its plant, resulting from the use of its own labor and material. During the same period considerable appreciation in both land and construction values had taken place. Under new management, an appraisal company was engaged to make an appraisal of buildings and equipment and the land was appraised by a real estate board, the values reported by each being much in excess of book values. The book values were adjusted to conform with appraisal values, the entire adjustment being credited to General Surplus account. In reporting upon an audit of this company, what adjustments or comment would you make? (C.P.A.)

227. If you found that the land of a manufacturing corporation had been reappraised at a higher value than its former book value which represented cost, and such increase had been carried to Profit and Loss, what would you do and say about it in your report of audit? What if the value had been reduced? State your reasons for your action fully. (C.P.A.)

228. Is it desirable to record an increase in the value of land which constitutes a portion of the plant of an undertaking even though the surrounding property undoubtedly is worth much more?

229. Discuss the treatment of expenditures for:

a. Ordinary repairs, and
b. Replacements

in their relation to capital expenditures, profit and loss, and reserve for depreciation. (A.I.A.)

230. Outline the instructions you would give to afford the head office of a company adequate control over expenditures at its various plants for additions and replacement repairs and to insure uniform and correct accounting treatment thereof. (A.I.A.)

231. By what accounting method may regular provision be made for the cost of replacements or renewals from time to time that are not in the line of ordinary repairs and that tend to maintain or to restore the value and efficiency of the plant? (C.P.A.)

232. A large office building (21 stories) recently erected and in first-class condition, was sold for $3,000,000.00. For the purpose of securing long-time leases and to use part of the building for offices of the company who purchased the building, the building was remodeled, the expense of which amounted to $900,000.00. How should this expense be taken care of on the books? (C.P.A.)

233. What would be the duty of an auditor should he find that expenditures for:

a. Additions and betterments had been charged to Maintenance

b. Repairs and renewals had been charged to Property accounts

Give reasons for answers.

Problems on Chapter IX

Problem 29

You are, for the first time, auditing the books of a paper manufacturing corporation, and on making an analysis of the Plant account you find the following condition:

Balance, January 1, 1919			$380,000.00
Land, purchased in January 1918, 600 ft. × 800 ft., deed not recorded		$190,000.00	
Buildings, brick and concrete, cost on above — finished in June, 1918		120,000.00	
Buildings, additions during year		70,000.00	
Debits:			
Part of operating loss from January 1, 1919, to December 31, 1923 (The operating loss, it is explained, was due to experiments and other causes incident to starting the plant and getting an organization together)		$280,000.00	
1919	$80,000.00		
1920	95,000.00		
1921	90,000.00		
1922	15,000.00		
Discount on Bonds		24,000.00	
1919	$10,000.00		
1920	12,000.00		
1921	2,000.00		
Interest on Bonds		11,500.00	
1919	$3,900.00		
1920	4,500.00		
1921	3,100.00		
Expense *in re* Bond Issue		1,200.00	
1919	$800.00		
1920	400.00		
Additions and Improvements to 12/31/23		210,000.00	
1919	$60,000.00		
1920	35,000.00		
1921	82,000.00		
1922	25,000.00		
1923	8,000.00		526,700.00
Forwarded			$906,700.00
Credits:			
Difference between par value and amount paid for stock purchased from a dissatisfied stockholder			26,000.00
Ledger balance of Plant account 12/31/23			$880,700.00

No depreciation considered; credit entry made November 1922.

Upon the basis of the above, prepare working sheet analysis of the Plant account, and schedule of adjusting entries necessary in the premises assuming the accuracy of the figures given.

Assuming that the Board of Directors advise you that it is their desire to have this account remain upon the books in its present shape, indicate the comments, if any, that you would make in your report on the audit.

Problem 30

A company desirous of extending its premises obtains estimates for the work from builders, the lowest of which is $20,000.00. On consideration of the circumstances the directors of the company decide to carry out the work by means of their own staff, and the additional premises figure in their Balance Sheet at $20,000.00 made up as follows:

Net cost of materials purchased	$ 6,500.00
Discount thereon transferred to Interest and Discount A/c	150.00
Labor on erection	11,200.00
Supervision by management (part of annual salaries)	500.00
Proportion of office expenses	250.00
Interest on outlay to date of completion	200.00
Profit, transferred to Profit and Loss account	1,200.00
Total	$20,000.00

Prepare working sheet analysis of the above, and indicate thereon all necessary comments and adjustments deemed necessary.

Problem 31

The American Manufacturing Company was incorporated January 1, 1923, and immediately contracted for the construction of a new plant, the contractor agreeing to accept as part payment an issue of $50,000.00 6 per cent first-mortgage bonds, dated January 1, 1923, interest payable January 1 and July 1, at a price of 80. The plant was completed and manufacturing operations commenced on July 1, 1923.

Assume that you were engaged to make an audit of the books of the above company after the books had been closed by the company's bookkeeper at December 31, 1923. After the mechanical accuracy of the figures had been proved, an analysis of the Profit and Loss account appeared as below:

Debits

Depreciation	$ 2,500.00
Organization expenses	1,100.00
Labor	160,000.00
Salaries	20,000.00
Other operating and administrative expenses	125,000.00
Purchases	340,000.00
Bond interest (July 1 coupons)	1,500.00
Bad debts (reserve)	1,400.00
Discount on bonds sold	10,000.00
Dividend on preferred stock	1,750.00
Cash discounts allowed	1,050.00
To balance	7,600.00
	$671,900.00

Credits

Sales	$610,000.00
Inventory, December 31	60,000.00
Cash discounts received	1,900.00
	$671,900.00

Draft such adjustments as you would prescribe, with suitable explanation for each. What is the amount of the net profit for the six months' period? (C.P.A.)

Problem 32

The following is a Trial Balance of the Bank Manufacturing Company at December 31, 1923, before closing:

Land	$ 2,000.00	
Buildings	25,250.00	
Machinery and equipment	31,120.00	
Materials used in manufacture	35,930.00	
Wages	13,560.00	
Salaries	3,500.00	
Repairs	740.00	
Insurance and taxes	850.00	
Office expense	1,560.00	
Depreciation	1,200.00	
Accounts receivable	24,130.00	
Accounts payable		$ 17,820.00
Bank loans		5,000.00
Inventory, December 31, 1923	8,210.00	
Accrued interest		150.00
Interest	150.00	
Sales		74,610.00
Trade discounts on sales	1,730.00	
Capital		50,000.00
Surplus		2,350.00
	$149,930.00	$149,930.00

An appraisal was made of the plant as of December 31, 1923, which showed the following values:

	Replacement Value	Depreciation Value
Land	$ 1,800.00	
Buildings	30,000.00	$27,000.00
Machinery and equipment	42,000.00	33,000.00

The board of directors approve the appraisal values, and pass a resolution to change the books to agree therewith.

Prepare Journal entries to adjust the books to agree with the value shown by the appraisal.

Prepare Balance Sheet and Profit and Loss Statement after giving effect to the appraisal adjustment.

Assume a fiscal period of 6 months; annual depreciation rates: buildings, $2\frac{1}{2}\%$; machinery and equipment, 5%. (C.P.A.)

Problem 33

The following is a financial statement of the Homestead Land Company on commencement of business, January 1, 1923:

Assets		Liabilities		
Land	$500,000.00	Capital stock		$100,000.00
Cash	70,000.00	Bonds:		
Discount on bonds	5,000.00	Authorized	$500,000.00	
		Less:		
		Not sold	25,000.00	475,000.00
	$575,000.00			$575,000.00

The land shown represents 10,000 acres, which were acquired at the rate of $50.00 per acre. The bonds issued by the company are dated January 1, 1923, maturing January 1, 1943, and bear interest at 5% per annum, payable July and January 1. Under these bonds the company is required to pay into the hands of a trustee, as a sinking fund for their redemption, the sum of $50.00 for each acre of land for which the company has received full payment and conveyed title. (Note that the company has complied with this requirement during the year and the trustee has advised, at December 31, 1923, that he had in his possession the sum of $153,500.00, of which sum $3,500.00 represented interest on the funds in his hands.)

The object of the company is to divide its property into 10-acre plots, which it sells at the rate of $75 per acre when paid for in cash, or $100 per acre when the plots are sold on the installment payment plan. This latter plan provides for the payment of $20.00 per acre in cash at the date of purchase, and the balance to be covered by four notes of

equal amounts, maturing one, two, three, and four years after the date of purchase; the first two notes not bearing interest, but the two latter to bear interest at the rate of 5% per annum. During the year ended December 31, 1923, 300 plots were sold for cash and title conveyed to the various purchasers; also during the same year 300 plots were sold on the installment plan as outlined in the foregoing.

Expenses not subject from inference from the foregoing:

Administration	$2,500.00
Salaries	5,000.00
Advertising	5,000.00
Taxes accrued, not paid . .	2,500.00

Prepare a Balance Sheet at December 31, 1923, and a Profit and Loss Statement for the year ended on that date. (C.P.A.)

Questions on Chapter X

234. Why ought depreciation to be considered when auditing the fixed asset accounts?
235. Is it a part of the duties of the auditor of the accounts of a stock company to consider the question of depreciation on assets, buildings, machinery, plant, etc.? Give reasons for your answer. (C.P.A.)
236. Distinguish between depreciation and:

   a. Obsolescence
   b. Depletion (C.P.A.)

237. It is contended that it is unnecessary to write off depreciation on:

   a. Freehold premises
   b. Plant and machinery

   provided that they are maintained in a full state of efficiency out of revenue. Give briefly your own views on this subject. (C.P.A.)
238. Name some reasons why it is important to keep distinct the various items of cost in the construction of a building containing boilers, engines, shafting, and heating plant. In the erection of the building itself, why should the cost of the foundations be kept distinct from the balance of the building? (C.P.A.)
239. Are depreciation charges properly considered to be in the nature of expense items, or as an application of the profits? Explain. (C.P.A.)

240. State whether depreciation is an element of the cost of manufactured products. If so, why? (C.P.A.)
241. It is agreed by the directors of a manufacturing company that certain depreciation should be allowed, but that it is desirable to let the plant accounts stand on the books at cost value. How would you as auditor manage to meet the situation? (C.P.A.)
242. Define and give the effect of the fixed percentage method of charging depreciation:

   a. On a flat basis
   b. On a reducing basis

243. Describe the sinking fund method of depreciation.
244. A machine costing $81.00 is estimated to have a life of four years, with a residual value of $16.00. Prepare a statement showing the annual charge for depreciation according to each of the following methods:

   a. Straight line
   b. Constant percentage of diminishing value
   c. Annuity method

   (for convenience in arithmetical calculation assume the rate of interest to be 10 per cent). Discuss the significance of each of the methods. (A.I.A.)

245. To what extent would you, as auditor, concern yourself in the matter of depreciation allowances? (C.P.A.)
246. What special considerations would influence you in fixing the rate of depreciation chargeable on:

   a. Buildings
   b. Machinery
   c. Tools and fixtures
   d. Patterns (C.P.A.)

247. Discuss concisely your conception of an auditor's duties in connection with an annual audit, where a difference of opinion exists between the auditor and the client as to the sufficiency of depreciation or depletion charges. (C.P.A.)
248. The balance in Machinery Depreciation account shows an increase for the year of the amount provided out of income which is computed at the rate of 4 per cent on the balance of the Machinery account at the commencement of the year.

The method of keeping the Machinery and the Machinery Depreciation accounts has been in force from the commencement of operations. Draft your comments as auditor of these accounts, assuming that no item other than those above mentioned call for any comments. (A.I.A.)

249. Explain the relationship between a sinking fund and an allowance for depreciation. It is claimed that in municipal enterprises the requirements that rates must be high enough to provide both for a sinking fund to pay off the bonds and also for a reserve for depreciation with which to replace the plant results in a double charge to consumers. Criticize or explain this theory. (A.I.A.)

250. What special duties has an auditor in connection with accounts relating to machinery and boilers owned by a corporation?

251. In auditing the accounts of a manufacturing company, what steps should be taken to verify the Machinery account balance? (C.P.A.)

252. Charges for the following items appear in the Machinery account of a manufacturing corporation:

a. New parts to replace others worn out
b. Engineer's salary
c. Labor for setting up additional new machinery
d. Expense of moving the old machinery from one part of the factory and setting it up in another

Do you see any objection to the above allocation of such charges? If so, what? (C.P.A.)

253. A manufacturing concern having increased its capital and invested considerable money in new machinery and in the reconstruction of old machinery, removes to a new location, and charges the cost of moving and the reconstruction of its old machinery to one account termed Installation. Explain fully how this account should be treated in closing the books of the company and give your reasons. (C.P.A.)

254. *a.* How should machinery and equipment be valued?
b. Discuss the value of a Plant Ledger to the auditor.

255. State briefly your duties as an auditor in reference to Machinery, the value of which has not been regularly depreciated. (C.P.A.)

256. Upon the audit of the partnership accounts of a manufacturing business the following condition is revealed: Machinery sold has been credited to regular Sales account. What would you deduce from these facts and what would you feel called upon to do in this instance? (C.P.A.)

257. A manufacturer purchased machinery for a new plant at a cost of \$50,000.00, and secured 5 per cent discount for cash payment. The salesman who sold same received a commission of 10 per cent, of which the salesman gave the purchaser one-half. Prepare Journal entries for the transaction. (C.P.A.)

258. When auditing the books and accounts of a concern operating a large machine shop, you find that the machinery and tools have been regularly depreciated each year, that their value as shown by the books is considerably less than the value shown by an independent appraisal, and that the firm has set up the higher values as shown by the appraisal on the books. To what account would you recommend the corresponding credit to go and for what reasons? (C.P.A.)

259. A large cotton mill has 200 looms in use, which are included in the Balance Sheet at \$200.00 each, which is the cost price after deducting an adequate yearly sum for depreciation. These looms originally cost \$300.00 each, and the cost of all necessary repairs has been charged to revenue. New looms can, however, be bought to-day for \$150.00 each, so there is a difference of \$10,000.00 between the present market price and the amount at which they are valued in the Balance Sheet. Should you consider it necessary to call attention to this fact in your auditor's certificate? Give your reasons. (C.P.A.)

260. Upon what basis should tools be valued? (C.P.A.)

261. How should small tools be treated in the accounts?

262. How should patterns and drawings, etc., be treated in the accounts?

263. How should the auditor value the plates of a book?

264. A book publishing company has brought out its first book. Plates capable of 100,000 impressions cost \$20,000.00; composition, proof-reading, etc., cost \$6,000.00; the author is to receive a royalty of 25 cents per volume on the books sold. As a first edition, 20,000 books are printed at a labor cost of \$2,000.00, and a further charge of \$1,500.00 to cover the proportion of general expenses. At the end of the year 10,000 copies had been sold for \$20,000.00; how would you prepare the accounts under the following conditions:

a. If it were ascertained that the demand for the book had practically ceased

b. If a steady demand would continue until the plates were worn out? (C.P.A.)

265. How should the auditor treat the asset of fixtures in connection both with their physical condition and with their location upon leased property?
266. What are secret reserves? How are they created? Is their use justifiable from the auditor's viewpoint? Discuss fully.
267. Describe the duty of the auditor in connection with the various methods encountered in handling containers in different businesses. (A.I.A.)
268. Discuss fully the question of depreciating the asset of goodwill. If the value of goodwill should be decreased or increased rather than be depreciated, discuss the situation. What is the effect of writing off goodwill?
269. A corporation was formed which acquired several plants, issuing therefor $17,000,000.00 bonds and $24,000,000.00 stock. It was well known at the time that this capitalization exceeded the true value of the assets (including goodwill) acquired, to an extent of $11,000,000.00. In the first year, after paying expenses and interest on bonds, the business yielded considerable net income. May such net income be used to pay dividends, or must it be first applied towards making up the $11,000,000.00? (A.I.A.)
270. Discuss the valuation of patents.
271. A corporation carries on its books an account with patents it has acquired from time to time by outright purchase during a period of ten years. They are still carried at original cost and it is decided to determine their present value, based upon the expiration of the life of the patents. Describe how you would proceed accurately to secure this result. (A.I.A.)
272. Discuss how the auditor should treat copyrights, comparing this treatment with that accorded patents.
273. Explain all the possible accounting problems which occur in connection with the account of Franchise. (C.P.A.)
274. A corporation organized for the purpose of manufacturing glue purchased formulas costing $5,000.00. Some time after operations had started a suit was brought which involved the use of the formulas and the corporation lost the suit and judgment was obtained for court costs amounting to $9,000.00. The formulas purchased were the principal assets, with the exception of raw materials purchased, and the corporation had no surplus. What was the status of the corporation? When paid, to what account should the $9,000.00 court costs be charged? (C.P.A.)

275. To what extent may the organization expenses of a corporation be regarded as a permanent asset and how should this account accordingly be dealt with? (C.P.A.)
276. In auditing the books of a manufacturing business you find that before manufacturing was commenced considerable sums were charged to Plant account for salaries, rent, and labor. Give your opinion as to whether or not such charges could, under any circumstances, be correct and, if they could, explain such circumstances. State another method of dealing with such items. (C.P.A.)
277. Classify the account of Organization Expenses Written Off as to subdivision of assets, liabilities, proprietary interest, income and expenses, under which it should be grouped. (C.P.A.)
278. At what point do expenses cease to be organization expenses and become operating expenses? (A.I.A.)
279. What treatment should be given expenditures of one year which are presumed to have been made with a view to increase the following year's profits?
280. Explain a method by which the auditor may analyze the account of Prepaid Insurance.
281. The assets of a concern as shown by the books include accrued interest. In your audit how would you verify the correctness of this item? (C.P.A.)
282. How should accounts be treated which cover royalties paid in advance that are to be recouped from future workings?

Problems on Chapter X

Problem 34

In auditing the Machinery account of The Blank Company as of 12/31/23, the auditor encounters the following facts:

Machinery

1923				1923			
Jan.	1	Balance	10,600.00	May		Sale of 1 old Type A	1,264.00
March		Purchase of 2 Type A	7,600.00	June		Sale of 1 old Type B	1,470.00
		Freight on above	400.00	Dec.	31	Balance	17,216.00
June		Cost of removing a disused Type B, to make room for a new machine	160.00				
		Cost of installation of 2 Type A	280.00				
Aug.		Alterations to 3 Type C, required by change in product	640.00				
Oct.		Cost of moving 1 Type A and 1 Type C from Building A to Building B to permit of more economical operation, including reinstallation	270.00				
			19,950.00				19,950.00
1924							
Jan.	1	Balance	17,216.00				

Upon investigation, an analysis of the opening balance shows 1 Type A machine purchased 6/30/21 for $3,000.00; 1 Type B machine purchased for $1,600.00 on 11/1/21; 3 Type C machines purchased 3/1/22 for $2,000.00 each. No further facts appear in the account.

The Reserve for Depreciation of Machinery accounts stands as under:

Reserve for Depreciation of Machinery

1922				1921			
Dec.	31	Balance	284.00	Dec.	31	J.	60.00
				1922			
				Dec.	31	J.	224.00
			284.00				284.00
				1923			
				Jan.	1	Balance	284.00

Draft adjustments and comments required as auditor, assuming that no other items than those above mentioned call for any comments.

Problem 35

A Trial Balance of the A. B. manufacturing firm taken December 31, 1923, contains the following accounts:

Plant and machinery	$35,000	Capital A	$40,000
Raw material 1/1/23	15,000	Capital B	20,000
Accounts receivable	25,000	Creditors' accounts	4,000
Cash	200	Sales	95,000
Loan account	7,000	Bank overdraft	5,000
Purchase material	38,000	Rent of steam power	1,500
Labor	24,000		
Traveling expenses	2,500		
Salaries, general	6,000		
Interest	600		
Stationery and printing	1,200		
Rent and taxes	3,500		
Discounts and allowances	1,250		
Fuel	3,000		
Insurance (plant) one year from July 1, 1923	1,150		
Freight inward	1,500		
General expenses	600		
	$165,500		$165,500

Stock on hand 12/31/23, $23,000; each partner to be credited 6% on his capital for one year; 3 per cent to be written off book debts for discount; 10 per cent of machinery and plant to be provided for depreciation; net profits to be divided $\frac{2}{3}$ to A, $\frac{1}{3}$ to B.

What is the value of the goodwill, figured on a 15 per cent basis? The average capital invested in the business has been $50,000; and the profits before interest charges being:

1918	$5,000
1919	10,000
1920	11,000
1921	3,000
1922	22,000

(C. P. A., adapted)

Problem 36

A small corporation, as of December 31, 1923, had a Patents account upon its books which showed the following:

Jan.	1,	1914,	Patent rights acquired by J. C. Smith in payment of stock subscriptions to Co.	$10,000.00
Dec.	31,	1914,	Application fees, attorney fees, etc.	1,000.00
Dec.	31,	1915	Do	500.00
Dec.	31,	1916	Do	500.00
Dec.	31,	1917	Do	2,000.00
Dec.	31,	1918	Do	12,000.00
Dec.	31,	1919	Do	8,000.00
Dec.	31,	1920	Do	7,000.00
Dec.	31,	1921	Do	7,000.00
Dec.	31,	1922	Do	7,000.00
Dec.	31,	1923	Do	10,000.00
			Total	$65,000.00

As of January 1, 1923, a new corporation was formed to take over the business of the old company, eight shares of new stock being given for each old one.

The date of the principal patent was January 1, 1917. It was decided that all expenditures on patents until that date should be capitalized, but that after that date, the account was to be adjusted by providing for writing off the principal patent by January 1, 1933, all expenditure, before and after January 1, 1917, being considered as connected with the principal patent.

Present working schedule showing the adjustment of the Patents account. (C.P.A., adapted)

Problem 37

In making an audit of the X Company as of December 31, 1923, the auditor encountered the following information concerning the policies of fire insurance carried:

Allemania — policy #1876523 — one year — expires 1/15/24 — on merchandise for $7,000.00 — premium $78.00
Connecticut — #438764 — one year — expires 1/15/24 — on mdse. — for $2,500.00 — premium $27.86
Century — #1769574 — one year — expires 1/15/24 — on buildings for $500.00 — premium $7.00
Century — #17844695 — one year — expires 1/15/24 — on mdse. for $2,500.00 — premium $27.86
L. & G. — #34276895 — one year — expires 1/15/24 — on mdse. for $3,000.00 — premium $33.43
Northern — #65873 — one year — expires 1/15/24 — on mdse. for $5,000.00 — premium $80.55
British-Am. — #853964 — one year — expires 1/30/24 — on mdse. for $5,000.00 — premium $55.72
National Union — #97786 — one year — expires 1/30/24 — on mdse. for $5,000.00 — premium $55.72

Century — #367412 — one year — expires 3/1/24 — on buildings for $1,000.00 — premium $14.00
Sun — #X-880463 — one year — expires 6/1/24 — on buildings and machinery for $2,500.00 — premium $52.42
Phoenix — #3274901 — one year — expires 10/1/24 — on buildings 40%, on mdse. 60% — for $5,000.00 — premium $73.71
L. & G. — #31353795 — 3 years — expires 10/1/26 — on office furniture for $1,500.00 — premium $18.51
Westchester — #90867 — one year — expires 10/15/24 — on equipment for $2,500.00 — premium $44.64
Franklin — #6675539 — one year — expires 12/1/24 — on merchandise for $15,000.00 — premium $131.82
Agricultural — #89645 — one year — expires 12/1/24 — on merchandise for $5,000.00 — premium $43.94

Prepare working sheet for the above, and adjustments necessary for the unexpired portions as of 12/31/23 assuming the Ledger account is titled "Insurance," is found under the general expense division, and shows a balance of $745.18.

Questions on Chapter XI

283. A firm is in the habit of giving and taking a considerable number of Notes Payable and Notes Receivable, and frequently discounts the latter. Four months elapse before the Balance Sheet is presented to you for audit. What steps would you take to verify the Notes Payable and Notes Receivable existing at the date of the accounts?
284. What documentary evidence would you require to prove the acceptance of bills payable by a factor against goods in transit? (C.P.A.)
285. How would you deal with the company's notes payable indorsed by an official of the company, in auditing a Balance Sheet as at June 30, 19—, to be certified by you? (C.P.A.)
286. In the preparation of a Balance Sheet, explain the basis upon which you would ascertain that notes payable were properly valued. (C.P.A.)
287. To what extent would you consider it necessary to verify the notes payable, and what reference to such verification would you make in your report? (C.P.A.)
288. State briefly your duties as an auditor in reference to loans from bankers. (C.P.A.)
289. To what extent should an auditor hold himself responsible for the correctness of notes payable? (C.P.A.)

290. A corporation issued its note for $30,000. The note became due during the term which you were auditing. A note for this amount, corresponding in all particulars with the note record, is submitted to you as evidence that the amount has been paid. Said note is marked "paid" but does not bear the signature, or paid stamp, of the bank to whom it is purported to have been paid. The treasurer asserts that possession by the corporation of this note is sufficient evidence of its payment. State (*a*) your opinion thereof, and (*b*) your reasons. (C.P.A.)

291. An auditor is engaged by a man who is buying an interest in a firm for the purpose of reporting upon the assets and liabilities of the firm as at a given date and upon the profits of the three years just prior. Upon the auditor's report, he purchased an interest in the firm and in its assets and liabilities. Six months later it is discovered that there were bills payable due by the firm amounting to $10,000 at the time the auditor made his examination and not reported upon by him and that these bills had continuously been due by the firm for one year prior to such examination, but no record of same had been made upon the books. Under what circumstances could the auditor be considered guilty of negligence in not discovering this fact and under what circumstances could he be considered entirely free of any blame in the matter? (C.P.A.)

292. State the method of analyzing the Notes Payable account.

293. A firm is indebted to one of its creditors in the sum of $45,000. The creditor agrees to accept notes with good indorsements for $50,000 in full settlement of the account, with the understanding that if any payment is not made at maturity, the whole debt, less such sum as may have been paid, shall be declared to be due by the creditor. After concluding this arrangement, the firm is succeeded by a corporation. The agreement covering the turnover provides that all debts of the firm shall be paid by the corporation. Only the indorsed notes for $50,000 are brought into the books of the company, and nothing is said regarding the agreement hereinbefore referred to respecting the original debt. You are asked to certify to the accounts thus set up. What course would you pursue? (C.P.A.)

294. In examining a list of creditors with the Ledger accounts for the purposes of a Balance Sheet, to what features of each account should you pay attention, apart from the mere arithmetical correctness of the extractions? Give examples of error or fraud which may be detected in this process.

295. Point out what you would like to find by way of system that would simplify the task of satisfying yourself that all outstanding liabilities of a business are properly taken up in the Balance Sheet. (A.I.A.)

296. Should provision be made out of revenue to provide for discount on accounts payable outstanding after the date of closing. Give reasons for your answer. (C.P.A.)

297. In an audit covering the year ended December 31, you discover that invoices aggregating $2,000 for bricks and other building materials to be used in the construction of an addition to the plant, were received after the books were closed, although the materials were actually received on December 15. As the materials were not taken into the inventory and the invoices were not on the books, would you require any adjustment? Give reasons. (C.P.A.)

298. In your audit the possibility of understating creditor balances must be rigorously guarded against. Set out all the practical checks you can think of in this connection.

299. A corporation in closing its fiscal year has some sixty items of current liabilities, which it enters on its books as follows:

(Sundry accounts)	53,827.34	
Accounts Payable		53,827.34

On the first day of the new year, the bookkeeper makes the following entry:

Accounts Payable	53,827.34	
(Sundry accounts)		53,827.34

How should the auditor deal with this condition? (C.P.A.)

300. Is an ordinary bank check drawn by the concern whose books you are auditing, to the order of the Receiver of Taxes and properly indorsed by him, a sufficient voucher for the payment of the taxes of this concern? Give reasons. (C.P.A.)

301. Under what circumstances, if any, may notes receivable discounted be omitted entirely from the Balance Sheet? Why? (C.P.A.)

302. How would you deal with notes receivable discounted in May of the current year and paid in July of the current year, in auditing the Balance Sheet as at June 30, of the current year, to be certified by you?

303. In the preparation of a Balance Sheet, explain the basis upon

which you would ascertain that notes receivable discounted were properly valued. (C.P.A.)

304. Explain how you would treat the liability as indorser on a note in your report on audit. (A.I.A.)

305. In making a detailed audit, what procedure would you follow to verify the accommodation notes discounted? (C.P.A.)

306. During the audit you are making of the accounts of a corporation, you become aware of a claim against the company which you think is likely to be enforced, but which the directors do not recognize, and for which they will make no reserve. What would you do in the circumstances? (C.P.A.)

307. The Motor Manufacturing Company negotiated a mortgage loan on their factory property for $35,000 at 6% per annum, payable semiannually. Principal payable $1,000 at each interest date, payments to be indorsed on the note. Interest coupon notes in decreasing amounts are also executed. In your audit you will find that all the notes and coupons were entered on the Notes Payable Record and were in agreement with the Ledger account. In view of the contract obligation, is the entry correct? How should the liability be shown on your financial statement? (C.P.A.)

308. How would you satisfy yourself that the assets of a company were not mortgaged or encumbered in any way? If an asset were so encumbered, indicate your Balance Sheet treatment. (C.P.A.)

309. In auditing a Balance Sheet, how would you ascertain the correctness of the item Mortgages? (C.P.A.)

310. What assets, other than real estate, are subject to valid liens? (C.P.A.)

311. A manufacturer owes $100,000 on his plant at 5% per annum, due at the end of five years from date. He secures an agreement, however, to pay the debt in equal annual installments which will include principal and interest. What amount is he required to pay each year? (C.P.A.)

312. A company is organized in New York to lend money on real estate mortgages in Florida. What examination should an auditor make of such mortgages, and how would he guard against duplicate mortgages on the same property? (C.P.A.)

313. Name five classes of bonds, describing briefly each class with regard to issue, purpose, redemption, etc. (C.P.A.)

314. An issue of mortgage bonds of the par value of $100,000 and running for five years has been sold at 90, the money to be used in the erection of new buildings. How should the transaction be recorded and why? (C.P.A.)

315. If a company sells its own bonds at a premium, is the premium received a legitimate profit of the company? (C.P.A.)

316. What proportion of $15,000 — commission paid for negotiating a sale of bonds, to run ten years — should be treated as an asset at the end of the first year? (C.P.A.)

317. A company authorizes its officers to borrow for its account $100,000 and give as security $200,000 of the first mortgage bonds of the company. How should this transaction be treated in the Balance Sheet? (C.P.A.)

318. Give the steps that should be taken to insure the statement of the full liability on the following items appearing in the Balance Sheet:

a. First mortgage bonds
b. Collateral trust bonds
c. Income bonds
d. Car trust notes (C.P.A.)

319. The $500 6% bonds of a corporation are issued at $450 redeemable at par, by ten annual drawings. How would you treat these bonds in the Profit and Loss Statement and Balance Sheet? (C.P.A.)

320. Give in detail a method for verifying the payment of interest on coupons from bonds of a company you are auditing, and state how proof of such payments should be presented to you. (C.P.A.)

321. How should unclaimed dividends be dealt with in the yearly Balance Sheet of a company?

322. An Oil Company has a capital stock divided as between common and preferred shares, the latter carrying a 6% cumulative dividend feature. For a number of years this company was successful and paid its preferred dividends and considerable dividends to the common stockholders. On June 30, 1923, it had an undivided profits account of a considerable amount. During the year ended June 30, 1924, no profits were made, and the undivided profits account was absorbed, leaving a small deficit, but this was not ascertained until the accounts were audited the following September. On July 1, 1924, the directors paid the preferred stockholders their usual dividend at the rate of 6% per annum. Give your views as to the correctness, or otherwise, of this action, and of the duty (if any) devolving upon the auditor in connection therewith.

323. Is a corporation bound to replace lost capital out of revenue before it can declare dividends? State reasons for answer.

324. Because of a slump in business during the past year, the directors of a corporation inform you as auditor that they do not intend to draw their fees. Indicate the treatment hereof that you would adopt.

325. A manufacturing company offers premiums costing 75 cents each to customers on the return of 100 of its wrappers. The company invested $5,000 in premiums and sold 500,000 units of the commodity during the year. You find that 300,000 of the wrappers have been redeemed, while it is estimated that 20 per cent will not be presented for redemption. At the end of the year how would you treat this matter in the preparation of the Revenue account and the Balance Sheet? (C.P.A.)

Problems on Chapter XI

Problem 38

Required: the Journal entries to be made on the books of all industrial parties mentioned properly to record the following transactions:

June 18, 1924. Walton & Company issued to Greaves Manufacturing Company a note for $947.69, payable three months after date, without interest.

July 1, 1924. Greaves Manufacturing Company transferred said note to the Holmes Manufacturing Company on account, less discount at 6 per cent.

July 28, 1924. Holmes Foundry Machines Company transferred said note to C. B. Dean & Company, less discount at 6 per cent in part payment of a bill on which they were entitled to a discount of $2\frac{1}{2}$ per cent on the amount paid. C. B. Dean & Company discounted the note at the bank at 6 per cent, receiving a draft on New York for the proceeds, less $\frac{1}{8}$ of 1 per cent exchange, which they remit to M. Grace & Company, in part payment of a bill on which they are entitled to a discount of 3 per cent on amount paid.

September 18, 1924. Walton & Company paid the note. (C.P.A.)

Problem 39

A company issues $1,000,000 bonds (denomination $1,000 each), dated January 1, 1922, bearing interest at 5% and maturing January 1, 1932. These bonds were sold at 80% of their par value.

The mortgage provides for a sinking fund to be created by annual payments of $50,000, and at December 31, 1923, the Trial Balance of the company's books among other items, shows the following which relate to these transactions:

Discount on bonds	debit . . .	$ 160,000
Trustee of sinking fund	debit . . .	102,000
First mortgage bonds	credit . . .	1,000,000

On January 1, 1924, the trustee purchased 113 bonds out of the funds in his possession at $900 each, which were canceled.

Indicate the Balance Sheet components, relative to the bond transactions, as of January 31, 1924, assuming a Balance Sheet audit being made for the fiscal year closing on such date.

Problem 40

A trading stamp company sells its stamps for $5 per thousand. They redeem these stamps in cash for $4 per thousand or in premiums which average to cost $4.50 per thousand. The income on the investments is $8,748 per year. They estimate that 5% of the stamps sold will lapse and never be redeemed. They anticipate the profit at the rate of 10% on the balance of stamps sold after deducting the redemptions and estimated lapses.

The Trial Balance of January 31, 1924, is as follows:

Balances— January 31, 1924:		
Cash	$ 23,510	
Stamps on hand at cost	1,525	
Investments in bonds	152,825	
Goodwill	100,000	
Premiums at cost	38,710	
Capital		$100,000
Accounts payable		6,010
Balances — January 31, 1924, which have not changed since December 31, 1923, and are to be adjusted by the January operations:		
Accrued interest	2,475	
Lapses	76,388	
Anticipated profits	23,577	
Unredeemed stamps		312,158
Surplus		8,717
Balances — January 31, 1924, showing operations for January:		
9,600,000 stamps redeemed in January in premiums	43,200	
4,912,500 stamps redeemed in January in cash .	19,650	
Stamps sold in January		65,000
Expenses January	10,525	
Coupons collected in January		500
	$492,385	$492,385

Submit Statement of Trading and Profit and Loss and a Balance Sheet. (C.P.A.)

PROBLEM 41

BALANCE SHEET — DECEMBER 31, 1923

ASSETS

Cash		$ 3,000.00	
Accounts Receivable		15,700.00	$ 18,700.00
Inventories:			
Finished Goods		$154,500.00	
Goods in Process		8,350.00	
Materials		55,000.00	217,850.00
			$236,550.00
Land		$40,000.00	
Buildings	$94,000.00		
Less — Reserve	14,000.00	80,000.00	
Machinery & Fixtures	$81,000.00		
Less — Reserve	21,000.00	60,000.00	180,000.00
Deferred Charges:			
Insurance and Taxes			1,100.00
Total Assets			$417,650.00
Deficit			52,850.00
			$470,500.00

LIABILITIES

Notes Payable	$275,000.00	
Accounts Payable	15,500.00	$290,500.00
Capital Stock:		
Preferred	$100,000.00	
Common	80,000.00	180,000.00
		$470,500.00

The foregoing was the Balance Sheet of a corporation, December 31, 1923, incorporated January 1, 1917, and during the year 1924 the following transactions occurred:

Sales, net	$550,000.00
Purchases, net — raw material	347,000.00
Raw material inventory increased	64,000.00
Labor	60,000.00
Total manufacturing expense	35,900.00
Process inventory increased	20,000.00
Finished goods inventory decreased	36,000.00
Total selling expense	35,000.00
Total administrative expense	26,000.00

Notes payable have been renewed as they became due, except that $100,000.00, held by the largest owners in the company, was donated to the company, July 1, 1924 . . . . $100,000.00

$5,000.00 of $3\frac{1}{2}$ per cent bonds have been bought . 5,000.00

$2,000.00 has been donated to charity 2,000.00

Notes: Depreciation on buildings, estimated life 47 years, beginning January 1, 1917

Depreciation on machinery, estimated life 27 years, beginning January 1, 1917

Accounts receivable were $45,000.00, and accounts payable $15,000.00 at the close of the year 1924

There was accrued interest payable $2,500.00, December 31, 1924

Ignore interest elements other than information gives

Prepare: Audited Balance Sheet. (A.I.A., adapted)

QUESTIONS ON CHAPTER XII

326. To what extent do you think it necessary to verify the outstanding capital stock of a corporation and what procedure would you follow in such verification? (A.I.A.)
327. What steps should be taken in the most complete possible verification of the capital stock account of a corporation in an audit for a year, if during that year the authorized capital was increased and new stock was issued, and certain shares were acquired and held by the company (assuming that it is legal to do so), and if:
    a. There is a registrar of the stock, and
    b. There is not (A.I.A.)
328. In auditing the accounts at the conclusion of the first fiscal year of a corporation formed to acquire an established business, what documents and records should be examined in addition to the ordinary books and subjects of an audit? (C.P.A.)
329. A partnership contract between A and B provides that each partner shall contribute $25,000 to a new business, and that on any capital brought in by either partner in excess of this amount he shall receive 6%. A contributes $10,000 additional, and the bookkeeper makes an entry in the books at the end of the year crediting A with 6% on $10,000, viz., $600, which is debited to B. Is this correct? Give reasons. (C.P.A.)
330. In auditing the books of a company for the first time after a reorganization, what should an auditor do to verify the opening entries? Give reasons. (C.P.A.)
331. In auditing the accounts of a private firm where there are several partners, to what points should the auditor look in order to be assured that the partners' accounts are correctly stated in the Balance Sheet? (C.P.A.)

332. Give reasons for or against the necessity of an auditor's verifying the Stock Ledger of a corporation. (C.P.A.)

333. In auditing the accounts of a corporation, what special precautions would suggest an inspection of the Minute Books, the Stock Ledger, the Bond Register, and a review of certain initial entries relating to the company's formation at a date prior to that covered by the immediate audit? (C.P.A.)

334. State two methods by which, under different conditions, an auditor may establish the actual amount of capital stock outstanding, and state the conditions that will require the use of one method, and the conditions that will require the use of the other method. (C.P.A.)

335. Describe the necessary precautions to be taken to safeguard a corporation when an executor presents a certificate of stock for transfer. Outline entries on the Transfer Books. (C.P.A.)

336. The officers of a company of which you are the auditor elected by the stockholders submit to you for audit a Balance Sheet in which the following item appears:

Miscellaneous reserves (including premium on stock)		$248,000.00
On investigation you find the item is made up as follows:		
General reserve	$86,000.00	
Operating reserves	6,000.00	
Provision for plant depreciation	46,000.00	
Provision for amortization of leaseholds	40,000.00	
Provision for bad debts	36,000.00	
Premium on capital stock sold	34,000.00	
	$248,000.00	

What recommendation would you make to the officers and what course would you take if your recommendations were not followed? (A.I.A.)

337. What is the difference between a reserve and a reserve fund? Explain fully. (C.P.A.)

338. It is customary with some institutions to carry secret reserves. State your views respecting that custom. (C.P.A.)

339. A company incorporated with a capital of $200,000, fully paid up, has sold its stock at a premium of 25%, thus realizing in cash $250,000. The by-laws, which cannot be amended except in a stockholders' meeting and after proper notice of such amendment having been mailed to each stockholder ten days prior to the meeting, contain a provision that the $50,000 so received over and above the capital stock at par, shall be placed to the credit of a special reserve account, and that this shall not be applicable to the payment of dividends. At the close of the first fiscal year, it is found that the company has made a net profit of $4,000 after charging $6,000 for depreciation on the buildings and machinery. The directors desire to pay a cash dividend of 5% and pass a resolution ordering that the depreciation referred to above shall be charged against the above special reserve account instead of against profit and loss, and they then proceed to declare a dividend of 5%. Discuss the above situation from the standpoint of an accountant. (C.P.A.)

340. The auditor of an incorporated company which has been accustomed to making investments in interest paying securities, in making his statement to the directors presented a Balance Sheet showing a surplus of $65,000. After discussion, the directors determined they did not wish to declare a dividend out of this surplus and gave their auditor the following order: "Decrease this surplus by investing $50,000 in the 5% bonds of the XYZ Railroad." Presuming there was an item in the aforesaid Balance Sheet of cash $75,000, what effect will the carrying out of the director's order have upon the surplus of $65,000? (C.P.A.)

341. In three successive fiscal years a manufacturing corporation values its supplies, etc., in hand at cost, with deductions for deterioration as follows: at the end of the first year, 5%; at the end of the second year, 10%; and at the end of the third year, 15%. With the inventory taken on this basis the profits for the second year did not equal the dividends declared, and surplus was intrenched upon; and in the third year the dividend paid was so much in excess of profits that the surplus was entirely exhausted and a debit balance created in the P & L account. Comment upon the report treatment of the above, as auditor. (C.P.A.)

342. A close corporation consisting of five stockholders, who also constitute the Board of directors, shows in its Balance Sheet as of December 31, 19—, a surplus item of $80,000. Thereupon the directors meet and vote a bond issue in the amount of $80,000 which is to replace the surplus item of $80,000, each stockholder to receive bonds in an amount proportionate to his stock holdings. The entry made upon the books of account was a debit to Surplus account, $80,000, and a credit to First Mortgage Bonds Payable, $80,000. As auditor, comment upon the above manipulation.

343. In making detailed audits some auditors verify all postings and footings of general and subsidiary Ledgers, even though

controlling accounts are kept. State reasons for and against such procedure. (A.I.A.)

344. On closing the books of a large business for the year, it is found that the profits are much less than were expected and much less than usual. What steps would you take to find the reason for this? (C.P.A.)

345. As a certified public accountant auditing the books of a manufacturing business that operated a supposedly highly developed cost system, what steps would you take regarding inventory values that were found to agree with the cost records?

346. In auditing the accounts of a manufacturing firm, what salient features of the cost Ledger should receive attention? (C.P.A.)

347. In auditing the accounts of a manufacturing contractor, what manipulations of the cost accounts should the auditor anticipate, to guard against inflating profits? (C.P.A.)

348. In auditing the accounts of a manufacturing company would you consider it proper to allow the Profit and Loss account to be credited with profit on uncompleted work? Explain.

349. What is the best method of stating the Profit and Loss account (Ledger) of a trading corporation so that it shall give the greatest possible desirable information?

350. What do you consider a complete checking of the General Journal? (C.P.A.)

Problems on Chapter XII

Problem 42

In auditing the Smith Manufacturing Company's books, you find in going through their minutes that a resolution was passed to give away one share of common stock with every share of preferred sold. At the end of their fiscal year, which period you are asked to audit, their books show as follows:

Real estate and buildings	$ 83,872.88	
Cash on hand and in bank	1,063.06	
Machinery and tools	10,000.00	
Fixtures	452.18	
Unearned insurance	160.94	
Office supplies	397.86	
Manufactured goods on hand	10,000.00	
Accounts receivable	16,840.62	
Capital stock preferred		$ 37,500.00
Notes payable		13,100.00
Accounts payable		14,601.43
Mortgage loan on real estate		35,000.00
Profit and loss account		22,586.11
	$122,787.54	$122,787.54

What comments would you make to the Smith Manufacturing Company? (C.P.A.)

Problem 43

The following Balance Sheet has been published by the X Company as showing the condition of the business after the sale of $10,000,000 of the first preferred stock and all of the second preferred stock noted therein:

Assets

Land, buildings, machinery	$ 7,000,000
Goodwill and patents	8,000,000
Investments	500,000
Cash	10,715,000
Inventories	13,000,000
Accounts and notes receivable	10,000,000
Other current assets	450,000
Deferred charges	335,000
	$50,000,000

Liabilities

Capital stock:	
7 per cent cumulative first preferred	$15,000,000
7 per cent cumulative second preferred	5,000,000
Common stock, 75,000 shares no par value	6,000,000
Notes and accounts payable	13,000,000
Dividends payable	52,500
Reserve for Federal Taxes	1,000,000
Reserve for depreciation	3,447,500
Surplus	6,500,000
	$50,000,000

A prospective purchaser of the stock asks you to tell him book values of each class of stock, amounts of net tangible and net quick assets for the appropriate class or classes of stock, and to advise him whether to purchase the first preferred at 95 or the common at 90.

The par value of the preferred stock shares is $100. It is expected that a quarterly dividend of $2 per share will be paid upon the common stock.

In your report mention such matters as it would seem advisable to know in addition to those contained in the statement given above. (C.P.A.)

Problem 44

A manufacturing corporation desires a certificate of its average annual profits for three years; after charging all costs, expenses, and depreciation and an allowance for bad debts, it is found that the profits for the first year were $62,000.00; for the second year, $64,000.00 plus $10,500.00 profit on sale of investments; and for the

third year, $72,000.00 plus $8,400.00 profit on the sale of real estate. Give the annual average profit to be certified. (C.P.A.)

Problem 45

X and Y formed a partnership, and it was agreed that X was to act as the manager of the firm. Profits were to be divided equally, after the following was taken into consideration: X was to receive a special bonus of 25% of the net profit. Before calculating this bonus or commission of X, the income statement showed profits of $10,000.00.

Determine the division of the $10,000.00 as between X and Y.

Questions on Chapter XIII

351. If employed by the officers of a corporation to make an audit, would you make any difference in your plans and in your report if you knew whether the audit was to be presented to a prospective purchaser of the stock, to a prospective purchaser of bonds, to the bank as a basis for the purpose of securing a loan, or to the stockholders at their regular annual meeting? If so, state the differences. (C.P.A.)
352. What are the duties of an auditor when he finds no charges made against maintenances or other accounts for depreciation of plant? Should he be concerned with the condition in this respect which obtains throughout the period prior to the one to be covered by his audit? How should he report to his client, having regard for the possibility of his report being used for the purpose of obtaining loans, obtaining additional capital in the business, or selling some part of the existing capital interests? (C.P.A.)
353. Discuss briefly the auditor's report. To what extent should details be put into a report? (C.P.A.)
354. Name some of the essential points you would deal with in an audit report. (C.P.A.)
355. To what extent would you criticize the management in your report? (C.P.A.)
356. Write a report of your audit in not more than 100 words:

    a. When the books are properly kept
    b. When the books are improperly kept

    using your own figures in both cases, and showing the improper entries in the last. (C.P.A.)
357. Write a report of your audit in not more than 100 words:

a. Where you have found irregularities in performance and deficiency in method, the scope of the audit being limited.
b. Same conditions except that the scope of the audit is not restricted, but that an audit to a previous date had been made.

358. Write a report for an audit made by you, indicating any condition in the office organization which you noticed that gave opportunity for fraud, with suggested remedy. (C.P.A.)
359. Write a report for an audit made by you, where you found a bad cost system in use.
360. In presenting a complete report of an audit made for a manufacturing concern, indicate the arrangement you would adopt of exhibits, schedules, etc., submitted.
361. If you are auditor for a corporation and you were instructed to send all copies of your report to the president, would you show your office copy to any director, not an officer, if so requested by him? (C.P.A.)
362. In case it is expedient to have a local accountant audit the accounts of a branch office of a wholesale trading firm for which you conduct the general audit, state matters on which you would require a report. The branch sells goods, collects from customers, pays all local expenses, and remits cash in round amounts to home office. (C.P.A.)
363. What do you understand by a certified Balance Sheet? (C.P.A.)
364. Differentiate between an audit report and an audit certificate. Indicate the responsibility under each.
365. What is meant by a qualified certificate? Give an illustration of a case in which a qualified certificate might properly be given and draft a qualification applicable to that case. (C.P.A.)
366. What are the essentials of an audit certificate in an audit for credit purposes? (A.I.A.)
367. Under what circumstances would an auditor be justified in refusing his certificate? (C.P.A.)
368. Draft a form of audit certificate to accompany a Balance Sheet which is to be published in the annual report of a corporation. (A.I.A.)
369. State your view as to the benefit accruing to a client receiving the following certificate from the accountant who had just made an audit of the client's books and accounts, to wit: "I hereby certify that in my opinion the foregoing statement of the assets and liabilities, also Profit and Loss account, is true and correct." (C.P.A.)

370. You find the following certificate appended to a Balance Sheet:

"May 15, 19—. The foregoing Balance Sheet is in accord with the books of the ABC Company. John Smith, auditor."

State what, in your opinion, are the limitations, if any, of such a certificate. Assuming you were afforded all reasonable facilities for the conduct of an audit of the company is it such a certificate as you would use? State definitely how you would amplify it. (A.I.A.)

371. Is an auditor justified in certifying to a Balance Sheet in case the books of account are not in balance? Give reasons. (C.P.A.)

372. You are called upon to make a cash audit and to submit a Balance Sheet thereunder, with your certificate attached. Write the certificate.

373. What percentage figures would you show on a comparative statement of profit and loss submitted to a new client? (C.P.A.)

374. In what respect and for what purpose could comparative statistics or percentages be made use of as regards the following:

a. Gross profit
b. Wages
c. Inventory of merchandise
d. Merchandise consumed
e. Costs of selling
f. Detection of fraud (C.P.A.)

375. State three methods of figuring percentages in comparing income and expenditures. Which method is best and why? (C.P.A.)

376. Explain the use which should be made of these percentages (see #375 above) in determining the administrative policies of a business. (C.P.A.)

377. Describe a proper arrangement of audit working papers when ready for filing. (A.I.A.)

378. Draw up an outline of a report on your audit of the accounts of a corporation that has recently erected a large apartment house. Assume your instructions covered the period of erection and at least one year of operation. (A.I.A.)

379. How would you proceed to audit the accounts of a local charitable organization? What evidence would you require as to the propriety of disbursements, and how would you ascertain that all receipts were duly recorded?

380. You are informed that during the period covered by a Balance Sheet audit, which you have made, a defalcation was going on in the petty cash which was not discovered by you. You are asked to write a letter of explanation to the board of directors. Explain what you would do, and draft such a letter. (A.I.A.)

381. How would you proceed in the audit of a trade union to ascertain whether the treasurer had charged himself with all dues paid by members to him?

382. Outline a program for a Balance Sheet audit with a test of operations for a suburban real estate development company. (A.I.A.)

383. Outline working papers and office records necessary to handle detailed semi-annual audit of a wholesale mercantile house. (C.P.A.)

384. Write a one-thousand-word statement containing instructions which you would give to a young fellow just entering your accounting office on the subject of working papers. (C.P.A.)

385. In investigation for suspected fraud, what preliminary scrutiny should the auditor make? (C.P.A.)

386. Describe how an audit of a set of books can be conducted without the knowledge or suspicion of the bookkeeper. (C.P.A.)

387. What precaution should an auditor take to guard against possible fraud? (C.P.A.)

Problems on Chapter XIII

Problem 46

The National Manufacturing Company began business on January 1, 1922, and its Balance Sheet handed to you as the auditor, dated January 1, 1923, is stated below:

Cash in Bank		$ 69,433	
Office fund		100	
Customers' accounts		273,842	
Inventory, raw materials		83,247	
Inventory, supplies		4,932	
Inventory, finished goods		42,761	
Office equipment		8,746	
Patents		125,000	
Real estate		320,000	
Buildings		175,000	
Machinery		265,000	
Apartment house property:			
Site	$10,000		
Building	30,000	40,000	
Bonds dated and issued December 31, 1922, maturing and payable at the end of 50 years, interest at 6%, payable semi-annually			$ 200,000
Premium on bonds issued			20,000
Sundry merchandise creditors			78,392
Reserve for bad debts			8,294
Reserve for depreciation on buildings			10,000
Reserve for depreciation on machinery			30,000
Capital stock, preferred 7%, cumulative from January 1, 1923			500,000
Capital stock, common			500,000
Surplus			61,375
		$1,408,061	$1,408,061

Upon audit of the accounts, the following items that appear upon the books were found correct, during year ended December 31, 1923:

	Debit	Credit
Labor	$468,932	
Salaries, and superintendence at $10,000	90,360	
Supplies, cash purchases	37,637	
Sales discount	18,395	
Customers' returns and allowances	8,474	
Sales		$1,545,572
Raw material purchases, average cost $22 per ton	639,034	
Shop expense	9,461	
Selling and delivery expense	86,017	
Rent from apartment house		4,000
Taxes, insurance, and repairs of apartment house	1,200	
Repairs on machinery and buildings	30,955	
Office expense	2,478	
Taxes	7,842	
Insurance	6,000	
Bad debts	2,407	
Old machine (cost $2,000) sold for		1,400
Interest on bonds	12,000	

Collections from customers amount to $1,502,927; payments to merchandise creditors amount to $664,626; loaned out on call on December 31, 1923, $50,000.

On March 1, 1923, the company bought an adjoining site on which it began in November, 1923, to erect an addition to the plant, to be completed by March, 1924. The price was $40,000, the company assuming a 6% $20,000 mortgage, payable December 31, 1923. The surveying and legal expenses paid amount to $200. Taxes assessed against the property, December 31, amount to $600.

Inventories at December 31, 1923: Supplies, $8,129; finished goods, $20,495; raw materials, 2,163 tons, the market price of which at December 31, 1923, is $24 per ton.

Real estate is estimated to be worth $350,000; dividends have been declared payable in April, 1924, of $3\frac{1}{2}$% on preferred capital stock, and $2\frac{1}{2}$% on common stock. Prepaid insurance premiums are $1,000.

Depreciation reserves to be credited covering: Buildings, $4,950; machinery, $17,625; office equipment, $875; bad debts, $7,716.

From the foregoing facts, assumed as being correct, prepare all exhibits and schedules deemed desirable for inclusion in the audit report on this assignment. Should any question of criticism develop, handle the matter as if you, as auditor, were required to give a Certificate of Audit as unqualified as possible.

Problem 47

With the facts of Problem 9 as a basis (see *ante*), prepare complete audit report. In this connection adjust the reserves as you deem desirable under the circumstances, and take into consideration the following:

1. $300.00 of the closing balance in the account of Rent of Store and Office is applicable to the office.
2. $1,250.30 of the closing balance in the account of Furniture, etc., in the store and office is applicable to the office. $1,000.00 of this amount was on hand in office furniture at the opening of business.
3. Manufacturing expenses include indirect labor.
4. Inventory, July 1, 1923, is raw material.
5. Interest and discount represents interest on notes and accounts payable.
6. Assume correctness of all facts as stated.

Problem 48

Mr. Manufacturer, Trial Balance, December 31, 1923

1	Machinery	$ 40,000	
2	Reserve — Depreciation of Machinery		$ 8,000
3	Factory Equipment	62,000	
4	Reserve — Depreciation of Factory Equipment		12,000
5	Large Tools	8,500	
6	Reserve — Depreciation of Large Tools		2,800
7	Patterns and Models	12,400	
8	Patent Rights	21,000	
9	Delivery Equipment	19,500	
10	Reserve — Depreciation of Delivery Equipment		7,000
11	Factory Fixtures	5,700	
12	Reserve — Depreciation of Factory Fixtures		1,100
13	Office Fixtures	3,000	
14	Reserve — Lease Expiration of Office Fixtures		500
15	Sales Department Fixtures	2,700	
16	Reserve — Lease Expiration of Sales Department Fixtures		450
17	Stocks	25,000	
18	Bonds	20,000	
19	Liberty Bonds	30,000	
20	Factory Building	160,000	
21	Reserve — Depreciation of Factory Building		5,000
22	Factory Land	250,000	
23	Life Insurance — Cash Surrender Value	30,000	
24	Cash in Bank	40,000	
25	Petty Cash Fund	200	
26	Cash Undeposited	4,800	
27	Accounts Receivable	250,000	
28	Reserve for Bad Debts		5,000
29	Notes Receivable	3,050	
30	Loans Receivable	4,000	
31	Inventory, Raw Material 1/1/23	180,000	
32	Inventory, Goods in Process 1/1/23	52,000	
33	Inventory, Finished Goods 1/1/23	75,000	
34	Salesmen's Advances	63,000	
35	Mortgage Payable — Land and Buildings		210,000
36	Accounts Payable		43,000
37	Notes Payable		99,050
38	Notes Receivable Discounted		2,000
39	Mr. Manufacturer, Capital Account		870,000
40	Mr. Manufacturer, Salary Account	14,195	
41	Sales — Finished Product		1,048,500
42	Sales — Partly Finished Product		19,000
43	Sales — Raw Material (at cost)		8,000
44	Sales — Scrap		1,800
45	Sales — Cash		15,000
	Total carried forward	$1,376,045	$2,358,200

	Total brought forward	$1,376,045	$2,358,200
46	Returned Sales	1,900	
47	Sales Allowances	9,000	
48	Discounts on Purchases		6,300
49	Dividends Received		1,200
50	Interest Income — Bonds		3,025
51	Interest Income — Bank		200
52	Federal Fees		200
53	City Fees		20
54	Rental Income		180
55	Profit — Sale of Fixed and Capital Assets		6,000
56	Raw Material Purchases	440,000	
57	Returned Purchases		6,000
58	Purchase Allowances		400
59	Infreight and Cartage	23,000	
60	Factory Wages — Productive	300,000	
61	Indirect Factory Labor	35,000	
62	Factory Clerk Hire	4,200	
63	Insurance on Factory Building	160	
64	Insurance on Machinery, Tools, Patterns	500	
65	Royalties on Leased Machinery	1,200	
66	Superintendent and Foremen's Salaries	5,600	
67	Small Tools	8,000	
68	Heat and Light	2,800	
69	Power	21,000	
70	Employees' Liability Premiums	4,000	
71	Repairs to Factory Building	1,800	
72	Repairs to Machinery	1,110	
73	Water Taxes	40	
74	Other Taxes	1,270	
75	Miscellaneous Factory Expenses	900	
76	Depreciation		
77	Salesmen's Salaries	30,000	
78	Salesmen's Commissions	10,000	
79	Salesmen's Expenses	15,000	
80	Salesmen's Traveling Expenses — Mileage	2,500	
81	Advertising	2,300	
82	Outfreight and Cartage	10,000	
83	Sales Department Insurance	650	
84	Commercial Agency Subscriptions	200	
85	Shipping Labor	2,000	
86	Shipping Supplies and Expense	1,000	
87	Depreciation		
88	Miscellaneous Selling Expenses	600	
89	Officers' Salaries	5,000	
90	Office Salaries	13,000	
91	Administrative Traveling Expenses	1,500	
92	Stationery and Printing	3,050	
93	Telephone and Telegraph	1,500	
94	Postage	2,000	
95	Office Supplies	410	
	Total carried forward	$2,338,235	$2,381,725

	Total brought forward		$2,338,235	$2,381,725
96	Heat and Light		700	
97	Office Rent		4,500	
98	Bonding of Office Employees		250	
99	Legal Expense		3,000	
100	Federal Taxes		7,000	
101	Real Estate Taxes		1,320	
102	City Taxes		1,000	
103	Cash Short and Over		45	
104	Water and Ice		55	
105	Towel Service		50	
106	Charity and Donations		7,000	
107	Depreciation			
108	Miscellaneous General and Administrative Expense		1,500	
109	Discounts on Sales		4,030	
110	Interest on Notes and Accounts Payable		2,800	
111	Interest on Mortgage Payable		3,000	
112	Bad Debts		6,000	
113	Collection and Exchange		700	
114	Loss on Sale of Fixed and Capital Assets		540	
	Totals		$2,381,725	$2,381,725

Comments on Trial Balance

(Numbers at left refer to the account numbers)

1. Certain machinery was sold in early 1923 for cash $6,000. The cost of this machinery was $7,400. Depreciation charged thereon to date was $1,400 (see account No. 2)
New machinery was purchased in 1923, as follows:

March	$10,000
August	13,000

Depreciation to be 10% per annum on reduced balance
2. There was a charge to this account of $1,400, mentioned above for account No. 1, which was written back
3. Appraised as being worth $47,000
5. Appraised at $5,700
7. Depreciation to be 30%
8. Purchased in March as follows:

No.	expires 1927	12/31	$15,000
No.	expires 1933	12/31	6,000

9. There was a credit in this account of $2,000, representing the original cost of an old auto given in January 1923, for $560, in part payment for a new car costing $2,600. The new car was received April 1, 1923. Depreciation on the old car to 12/31/22 was $777.78 (see account No. 10). Depreciation to be $33\frac{1}{3}$%.

10. There was a charge to this account of $777.78 (mentioned in 9 above), which was written back in January 1923
11. Depreciation to be 10% per annum on reduced balance
13. Reverts to owner in 1928 when lease expires (12/31/28)
15. Reverts to owner in 1928 when lease expires (12/31/28)
17. Stock dividend of $2,000. Entry was debit and credit to Stock Dividend account, only for purposes of record
19. Original subscriptions to the fourth loan at par
20. Depreciation to be 3% per annum
22. Vacant lots sold during 1923 for $35,000. Cost of these lots in 1921 was $29,000
23. The cash surrender value has increased $1,200. Premiums have been charged to account No. 108
25. A fixed fund
30. Includes loans to Jones & Co., now bankrupt. Dividend to be $1,000; *i.e.*, $33\frac{1}{3}$%
31. Ending inventory $190,000, at cost; market is $187,000
32. Ending inventory $64,000, at cost; market is $63,000
33. Ending inventory $90,000, at cost; market is $90,000
35. Mortgage reduced $5,500 during year due to lot sales (see account No. 22)
39. Credited during year with salary $30,000 (account No. 40 was charged)
40. This is a drawing account
50. Liberty Bonds, $1,275 (principal of $30,000)
New York State Bonds, $800 (principal of $16,000)
Industrials, $950 (principal of $4,000)
52. Special work for Government
53. Jury service
55. From sale of lots
61. Accruals 12/31/23 are $600
62. Accruals 12/31/23 are $500
63. Unexpired is none
64. Unexpired is $75
66. Amount unentered is $1,200
67. Amount per physical inventory is $6,800
75. Inventory 12/31/23 is $450
77. Accruals 12/31/23 are $2,000
78. Commissions earned, not booked $1,000
79. Unentered expense vouchers 12/31/23 are $900
80. Unused mileage is $550
81. Unused advertising is $350
83. Unexpired is $110
84. Unused is $50
86. Inventory is $250
89. There was a credit in this account of $600, representing accrual on 1/1/23

90. Accruals 12/31/23 are $250
92. Inventory 12/31/23 is $200
94. Stamps on hand $150
95. Inventory 12/31/23 is $75
100. Actual amount paid in 1923 was $16,000
101. Taxes on factory property paid during 1923, — including $600 for sewer and street construction
102. State personal taxes paid in 1920
106. Donations made were as follows:

St. Mary's Infants Home	$1,200	Organizations not operated for profit of stock holders.
Onondaga Orphans Home	2,000	
Provident Boys' Home	2,000	
St. Joseph's Hospital	1,000	
Hospital of Good Shepherd	800	

108. Life insurance premiums for the year were $1,400

112.	Total Payt.	Received	Loss
A. B.	$4,000	$1,000	$3,000
C. D.	2,000		2,000
E. F.	1,500	500	1,000
	$7,500	$1,500	$6,000

114. Loss covers auto exchange (see account No. 9)

Requirement:

Assuming the accuracy of the facts above given, prepare report of audit.

Comment: Above problem may be used, also, as basis for preparation of Federal Income Tax return. If so, assume Mr. Manufacturer a married man, with no children.

Problem 49

You are engaged to make a Balance Sheet audit of the A. B. Co., a corporation trading in certain patented machines, of which it owns the patents, and in certain accessory materials necessary to their operation. The company owns no plant but buys its stock in trade from the actual manufacturers. The bulk of its business consists of outright sales, but it also leases some of its machines at a nominal rental under contracts which bind the lessees to buy from itself all the accessory material. It owns four patents, which are 20, 19, 18, and 5 years old, respectively. For the first three patents it gave practically all of its capital stock and some cash; the remaining patent covers valuable improvements on the original machines invented by one of the officers and is assigned to the company without compensation, but the company has charged the expenditures, including part of officers' salaries,

on these improvements to the property account. No amortization of the patents has ever been charged off.

On your arrival at the company's office on January 15, 19—, the following Balance Sheet of December 31, 19— (*ante*), is handed to you:

Balance Sheet — December 31, 19—

Assets

(a) Cash: in banks	$¢	
in petty cash fund	$¢	$¢
(b) Notes receivable: trade, officers' and other, mingled in one account without distinction		$¢
(c) Accounts receivable: trade, officers' and other, not classified, and no provision for bad debts		$¢
(d) Investments: stocks, treasury stock, and Liberty and other bonds, at cost, which is higher than present market value		$¢
(e) Inventories: from perpetual inventory book, no actual inventory ever having been taken		$¢
(f) Contract machines: machines leased under contract, the cost values thereof being about 25% of the total amount charged to this account, the difference being said to be the cost of building up this particular part of the business in past years		$¢
(g) Property account, includes cost of patents, expenditures for improvements thereon, patterns, designs, office furniture, and fixtures, etc., not classified in any way		$¢
Total assets		$¢

Liabilities

(h) Notes payable: trade and banks, not classified	$¢	
(i) Accounts payable: trade	$¢	
Total Liabilities		$¢
(j) Capital stock: authorized and outstanding	$¢	
Surplus	$¢	
Net worth		$¢

State how you would proceed to verify each item of the foregoing Balance Sheet, in view of the facts submitted, and also what steps, if any, you would require the company to take before you would sign an unqualified certificate.

(Number each answer to correspond with the item number on the Balance Sheet.) (A.I.A.)

Problem 50

Upon the basis of the following list of accounts and records, prepare an audit plan, assuming that this business has been in existence six months, is owned by a small number of stockholders, is of moderate size, its capital not being in excess of $50,000.00, and its capital all paid in in cash. The company is agent for a medium priced automobile:

List of Accounts

Imprest Fund	Sales — Accessories
Cash on Deposit	Sales — Supplies
Notes Receivable	Purchases — Cars
Customers	Purchases — Parts
Inventory	Purchases — Accessories
Machinery, Tools, & Equipment	Purchases — Supplies
Office Furniture & Fixtures	Wages
Deferred Items	Commissions
Creditors	Advertising
Payroll Unpaid	Demonstration
Deposit	Shop Expense
Capital Stock	Salaries
Surplus	Rent
Profit & Loss	Light & Heat
Sales — Cars	Insurance
Sales — Parts	Sundry Expense

List of Records

Stock Certificate Book	Note Register
Stock Book	Cash Receipts Register
Minute Book	Check Register
Purchase & Expense Register	Petty Cash Record
Car Record	General Journal
Inventory Record	Customers Ledger
Payroll	Creditors Ledger
Sales Binders	General Ledger
Sales Recaps	

The original records are columnar in form, and loose-leaf; the Ledgers are loose-leaf.

Problems on Chapter XIV

Problem 51

SYRACUSE TRADING COMPANY

Balance Sheet — December 31, 1923

Assets

Current Assets:			
Cash on Hand and in Bank		375.70	
Accounts Receivable:			
Customers	4,250.60		
Employees	438.30	4,688.90	
Merchandise Inventory		8,921.10	13,985.70
Furniture and Fixtures			586.20
Deferred Charges:			
Insurance		135.00	
Office Supplies Inventory		72.10	207.10
			14,779.00

Liabilities

Current Liabilities:			
Notes Payable		2,700.00	
Accounts Payable		5,120.00	
Accruals:			
Expenses	60.00		
Interest on Notes Payable	42.80	102.80	7,922.80
Reserves:			
Uncollectible Accounts Receivable		428.70	
Depreciation of Furniture and Fixtures		627.50	1,056.20
Capital Stock			5,000.00
Surplus			800.00
			14,779.00

The surplus of $800.00 represents the profit for the first year of operations. Net sales were $42,812.51; cost of sales $30,281.18. Operating expenses were: Salaries, $5,173.00; rent $2,500.00; discounts $1,835.62; sundry expenses $2,000.67; depreciation $153.08. A note payable of $1,000.00 is due on February 1, 1924.

Based upon the above, including the rectifying of any criticisms that might be suggested, prepare a reasonable schedule of requirements for the following six months, assuming sales will reach a net of $25,000.00, so that this company will not be any the worse at the end of such time than at present.

Prepare as part of the report:

1. Estimated Balance Sheet in comparative form
2. Estimated Profit and Loss Statement
3. Statement of Cash Requirements for the six months' period

Sundry information which might prove useful:

Inventory, January 1, 1923, $3,042.08; sundry expenses analysis: store expenses $1,225.50; advertising $520.80; stationery and postage $162.75; insurance $91.62. The books are to be audited each year by a C.P.A.

Problem 52

The net profit of the Ajax Manufacturing Company has approximated $200,000.00, each six months. As a basis for preparing the budget for the ensuing six months' period, the following estimates have been compiled:

Finished Product on Hand — End of Last Period (Cost)

Article 1 — 15,000 units @ $4.00	$60,000.00
Article 2 — 7,000 units @ 3.50	24,500.00
Article 3 — 2,000 units @ 3.00	6,000.00
	$90,500.00

Estimated Production — New Period (Cost)

Article 1 — 60,000 units @	$ 4.00	$240,000.00
Article 2 — 35,000 units @	3.50	122,500.00
Article 3 — 25,000 units @	3.00	75,000.00
		$437,500.00

Estimated Shipments — New Period (Sales Price)

Article 1 — 70,000 units @	$10.00	$700,000.00
Article 2 — 35,000 units @	8.00	280,000.00
Article 3 — 20,000 units @	6.00	120,000.00
		$1,100,000.00

Estimated Sales Orders to be Secured (Sales Price)

Article 1 — 85,000 units @	$10.00	$850,000.00
Article 2 — 40,000 units @	8.00	320,000.00
Article 3 — 20,000 units @	6.00	120,000.00
		$1,290,000.00

Sales Orders Unfilled — End of Last Period (Sales Price)

Article 1 — 15,000 units @	$10.00	$150,000.00
Article 2 — 5,000 units @	8.00	40,000.00
Article 3 — 2,000 units @	6.00	12,000.00
		$202,000.00

Commercial Expenses of all kinds estimated as $350,000.00.

Prepare whatever budget statement or statements seem desirable in the premises, with accompanying comment that appears necessary.

INDEX

Account analysis, 106
Accounts payable, 190
Accounts receivable
  Audit of, 118
  Branch customers, 126
  Circularization of, 134
  Components of, 124
  Other than customers, 126
  Pledged, 134
  Schedule of, 125
  Valuation of, 129
Accrued liabilities, 193
Additions, 171
Aging accounts receivable, 128
Allowances on sales, 120
Analysis of an account, 106
Appendix, 281
Apportionment of expenditures between capital and revenue, 13
Assets
  Current, 100
  Fixed, 162
  Sinking fund, 115
  Title to, 100
  Verification scope, 98
Attitude of auditor to client's employees, 32
Audit
  Balance sheet, 23
  Certificate of, 235
  Detailed, 21
  Plan of, 64, 70, 121, 125, 144
  Report, 227
  Scope of, 13
Auditing
  Advantages, 3
  Cash, 65
  Definition of, 1
  Mechanics of, 66
  Purposes, 3
  Relation to accounting, 2
Audit of
  Accounts receivable, 118
Audit of
  Cash after period's close, 81
  Inventories, 139
  Investments, 109
  Notes receivable, 96
  Securities, 96, 109
Auditors
  Classes of, 29
  Equipment on case, 31
  Legal responsibility of, 11, 28, 31
  Qualifications of, 10
Audits
  Kinds, 21
Automobiles, 176

Bad and doubtful debts, 131
Balance sheet audit, 23
  Cash, 92
  Notes receivable, 108
Bank
  Confirmation, 56
  Pass book, 80
  Reconciliations, 76
Barometric factors, 247
Basic working sheets, 59
Bond scrip, 200
Bonds payable, 198
Branch customers, 126
Budget, 244
  Form, 254
  Procedure, 252
Buildings, 169
Business
  Barometers, 245
  Budget, 244
  Cycles, 246
  Thermometers, 245

Capital, 203
  And revenue, 13
Capital stock, 205
  With no par value, 210
Case preliminaries, 31

Cash
  Count, 44
  Internal checks on, 72
  Petty, 90
  Proved through other accounts, 90
  Sales, 119
  Schedule for, 44
  System suggestions, 94
  Verification variations, 73, 83
Cash book
  Columnar form, 91
  Footings of, 91
Certificate of audit, 235
Certificate of bank confirmation, 56
Charge and discharge principle, 20
Charges deferred, 181
Charts and graphs, 233
Checking
  Accounts receivable schedule, 125
  Footings, 66
  Postings, 66
Check kiting, 82
Check marks and their use, 41
Checks as vouchers, 88
Circularization of accounts receivable, 134
Classes of
  Audits, 21
  Errors, 6
  Professional auditors, 29
Closing the audit, 227
Co-insurance, 173
Color and quality of working paper, 36
Collectibility of accounts receivable, 128
Columnar cash book, 91
Commencing the audit engagement, 41
Comments in report, 234
Components of
  Accounts receivable, 124
  Inventory, 139
  Report, 231
Confirmation by bank, 56
Construction, 171
Construction of customers' control, 124
Contact with client's employees, 32
Content and filing of working papers, 39
Content of basic working sheets, 59
Contingent liabilities, 105, 197
Copyrights, 180
Count of
  Cash, 44
  Notes receivable, 50
  Securities, 52
Credit sales, 119
Criticism of working papers, 229
Current assets, 100
Customers' control constructed, 124
Cycles, 246

Deferred charges, 181
  Income, 196
Depreciation, 172, 174, 175, 176, 177
Detailed audit, 21
  Cash, 92
  Notes receivable, 108
Detection of errors, 6
Development companies, 168
Discounted notes receivable, 105
Discounts on sales, 133
Dividend investments, 112
Dividends unpaid, 194
Doubtful and bad debts, 131
Drawings, 175
Duties of junior assistant, 30

Economic function of auditing, 8
Engagement
  Equipment, 31
  Letter, 18
  Preliminaries, 31
Equipment, 174
Errors
  Detection of, 6
  Trivial, 49
Exchange, collection, and interest items, 75
Exhibits, 231
Expenditures apportioned between capital and revenue, 13
Expense, 203, 218
  Prepaid, 181

Federal Reserve suggestions
  Accounts payable, 193
  Accounts receivable, 137
  Bonded mortgage debt, 201
  Capital stock, 207
  Deferred charges, 183
  Fixed property, 178
  Inventory, 158
  Notes and bills payable, 190
  Notes receivable, 105
  Sales, 217
  Securities, 116
  Sundry, 223
Filing and content of working papers, 39

Finished goods, 152
First audit, 17
Fixed assets, 162
Fixed liabilities, 198
Fixtures, 176
Flasks, 175
Footing cash book, 91
Form of
  Audit report, 238
  Budget, 254
Fraud, 4
  And internal checks, 15
Furniture, 176

General ledger trial balance, 58
Goods in process, 152
Goodwill, 180
Graphs and charts, 233

Holding and subsidiary company inventories, 158
Holdings in subsidiary companies, 208
Horses, 176

Illustrative
  Audit plan, 70
  Balance sheet, 98
  Study problem, 255
Improvements, 171
Income, 203, 214
  Deferred, 196
Index of working papers, 228
Indorsed checks as vouchers, 88
Inspection and verification of notes receivable, 103
Intangible assets, 180
Interest
  Accrued, 194
  Investments, 110
Internal check, 15
  Accounts receivable, 118
  Cash, 72
  Inventory, 143
  Sales, 122
Inventories audit, 139
Investments
  Audit of, 109
  Balance sheet inclusion, 114
  Dividend return, 112
  Interest return, 110
Items
  Prepaid, 181
  Treated as sales in error, 120
Journal, 225

Kinds of
  Audits, 21
  Errors, 6
Kiting of checks, 82

Land, 164
  Companies, 168
Leased premises, 173
Legal
  Regulation of profession, 9
  Responsibility of auditors, 11, 28, 31
Letter of
  Engagement, 18
  Submittal, 238
Liabilities, 185
Liability, contingent for notes discounted, 105
Loans payable, 187

Machinery and equipment, 174
Manufacturing inventories, 150
Mechanics of auditing, 66
Minutes, reading the, 62
Mortgages payable, 198

New audit assignment, 17
No par value capital stock, 210
Notes payable, 187
Notes receivable
  Audit of, 96
  Count of, 50
  Discounted, 105
  Schedule of, 50

Opening entries, 207
Overdrafts on balance sheet, 94

Pass book, bank, 80
Patents, 180
Patterns, 175
Payables, 187
Petty cash, 90
Plan of audit, 64
  Accounts receivable, 125
  Cash, 70
  Inventories, 144
  Sales, 121
Pledged accounts receivable, 134
Preliminary work on an assignment, 43
Prepaid expense, 181

Preparation of
Accounts receivable schedule, 125
Working papers, 35
Principle of charge and discharge, 20
Problem of the inventory audit, 140
Problems in Auditing
Chapter II, 287
Chapter III, 293
Chapter IV, 298
Chapter V, 304
Chapter VI, 310
Chapter VII, 316
Chapter VIII, 324
Chapter IX, 332
Chapter X, 342
Chapter XI, 350
Chapter XII, 356
Chapter XIII, 362
Chapter XIV, 370
Term problem, 255
Procedure of
Bank reconciliation, 76
Budget making, 252
Professional auditors, classes of, 29
Professional regulations, legal, 9
Profit and loss account, 213
Proprietorship, 203
Proving
Accounts receivable through other accounts, 136
Cash through other accounts, 90
Manufacturing inventories in total, 155
Trading inventories in total, 149
Purposes of working papers, 35

Qualifications of an auditor, 10
Quality and color of working paper, 36
Questions in auditing
Chapter I, 283
Chapter II, 285
Chapter III, 291
Chapter IV, 297
Chapter V, 301
Chapter VI, 306
Chapter VII, 312
Chapter VIII, 319
Chapter IX, 326
Chapter X, 336
Chapter XI, 345
Chapter XII, 353
Chapter XIII, 358

Raw material, 150
Reading the minutes, 62
Real estate, 164
Reconciliation of bank account, 76
Regulation of profession, legal, 9
Report of audit, 227
Components, 230
Reserves, 203, 208
Responsibility
Inventory audit, 142
Legal, 11, 28, 31
Return sales, 120
Revenue and capital, 13

Sales
Allowances, 120
Cash, 119
Credit, 119
Discounts, 133
Returns, 120
Schedules, 232
Accounts receivable, 125
Cash, 44
Notes receivable, 50
Securities, 52
Scope of
Asset verification, 98
Audit, 13
Scrap, 156
Scrapped properties, 177
Scrip, bonds, 200
Securities
Audit, 96, 109
Count, 52
Schedules, 52
Sinking fund assets, 115
Small tools, 175
Statements, 230, 240, 242, 250
Stock of subsidiary companies, 110
Stores, 150
Study problem, 255
Submittal letter, 238
Subsidiary company
Holdings, 208
Inventories, 158
Stock, 110
Suggestions of auditor on cash system, 94
Supervising the taking of an inventory, 157
Surplus, 209

Taking the inventory, 157
Taxes accrued, 195

Term problem, 255
Title to assets, 100
Tools, 174
Trademarks, 180
Trading inventories, 144
Trading transactions related to sales, 118
Treasury bonds, 200
Trial balance of general ledger, 58
Trivial errors, 49

Use of
Audit plan, 64
Budget, 250
Check marks, 41

Verification of
Cash, 73, 83
Customers' balances, 123, 129
Liabilities, 185
Sales, 122

Vouchers, 20
Payable, 190
Vouching, 66
Credits, 86
Debits, 84, 88, 89

Wages accrued, 195
Wagons, 176
Work in process, 152
Working papers, 35
Color, 36
Content, 39
Criticism, 229
Filing, 39
Index, 228
Quality, 36
Rulings, 37
Working trial balances, 58, 59

Date Due

~~Mar 3~~			
~~Nov 19~~			
~~Sept 14~~			
~~Oct 20~~			
~~Oct 29~~			
~~Nov 11~~			
~~Nov 30~~			
~~Jan 17~~			
Feb 18			
May 20			
Dec 11			
MAR 19 1949	4/2		
JUL 1 1949	7/15		
AUG 14 '50	8/28		

END OF
TITLE